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# Divorce Checklist & Financial Information





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# Getting Divorced Checklist

General information	Yes	No	N/A
1. Has relevant personal information been gathered? <ul style="list-style-type: none"> <li>• Each spouse's name, date of birth, and Social Security number</li> <li>• Names and birth dates of children</li> <li>• Date and place of marriage and length of time in present state</li> <li>• Information about prior marriages and children</li> <li>• Date of separation and grounds for divorce</li> <li>• Current occupation of spouses and name/address of employers</li> <li>• Education and degrees of each spouse</li> <li>• Name, address, and telephone number of attorney</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. Has financial situation been assessed? <ul style="list-style-type: none"> <li>• Income of each spouse</li> <li>• Expenses of each spouse</li> <li>• Assets of the spouses (joint and separate)</li> <li>• Liabilities of each spouse</li> <li>• Employee benefits each spouse is entitled to</li> <li>• Life, health, and disability insurance policies owned by each spouse</li> <li>• Credit reports</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Notes:			
Property settlements	Yes	No	N/A
1. Does prenuptial agreement exist?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. Do spouses reside in a community property state?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Have all assets been listed, valued, and classified as joint or separate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Have the tax bases of all assets been determined?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. If assets will be transferred or sold, have tax consequences been calculated and explained to client?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. Have loans and other liabilities on the properties (or otherwise) been listed and considered?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7. Is there a family business?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Notes:			
Alimony and child support	Yes	No	N/A



1. Have tax consequences of classifying support as alimony or child support been reviewed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. Has physical custody of children been determined?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Has legal custody of children been determined?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Have visitation parameters been established for the noncustodial parent?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. Will alimony be paid?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Notes:			
<b>Marital home</b>			
	<b>Yes</b>	<b>No</b>	<b>N/A</b>
1. Will home be transferred to either spouse as part of settlement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. If yes, has cost basis been reviewed for improvements?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Has amount of outstanding mortgage been calculated?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Will the principal residence be sold to a third party?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. If yes, has the tax cost (if any) been computed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Notes:			
<b>Retirement planning</b>			
	<b>Yes</b>	<b>No</b>	<b>N/A</b>
1. Have retirement plans been listed and interests in retirement plans been reviewed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. Will the divorce decree provide a payout from the plan? If so, will a qualified domestic relations order (QDRO) be used?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Should beneficiary designations be changed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Will any IRS penalties apply?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. Can retirement money be rolled over to IRA?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Notes:			



Tax planning	Yes	No	N/A
1. If already divorced, was divorce finalized by year-end?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. If still married at year-end, agree to file jointly?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Have joint filing risks been discussed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Has separate maintenance decree been obtained to permit filing as unmarried or head of household?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. Have head of household conditions been met?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. Has it been decided which spouse will get dependency exemption?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Notes:			
Other	Yes	No	N/A
1. Should will and trust be changed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. Should insurance policy beneficiaries be changed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Should banks and other creditors be notified of divorce and signatures changed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Will either spouse's health insurance plan cover the children post-divorce? Cover spouse?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. Has budget been revised to account for changes in income and liabilities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. Does credit need to be repaired or established?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Notes:			



# Dealing with Divorce

Divorce can be a lengthy process that may strain your finances and leave you feeling out of control. But with the right preparation, you can protect your interests, take charge of your future, and save yourself time and money. You certainly never expected divorce when you cut the wedding cake--you and your spouse planned on spending the rest of your lives together. Unfortunately, the fairy tale didn't work out, and you're headed for a divorce. So where do you begin?

## First things first: should you hire an attorney?

There's no legal requirement that you hire an attorney when divorcing. In fact, going it alone may be a sensible option if you're young and have been married only a short time, are childless, and have few assets. However, most divorcing couples hire attorneys to better protect their interests, even though doing so can be expensive. Divorce attorneys typically charge hourly rates and require you to submit retainers (lump sums) up front. The charges will depend on the complexity of the case, the reputation and experience of the divorce attorney, and your geographic location.

You should know that if you're a homemaker or earn less income than your spouse, it's still possible to obtain legal representation. You can submit a motion to the court, asking a judge to order your spouse to pay for your attorney's fees.

If you and your spouse can agree on most issues, you may save time and money by filing an uncontested divorce. If you can't agree on significant issues, you may want to meet with a divorce mediator, who can help you resolve issues that the two of you can't resolve alone. To find a mediator, contact your local domestic relations court, ask friends for a referral, or look in the telephone book. Certain attorneys, members of the clergy, psychologists, social workers, marriage counselors, and financial professionals may offer their services as mediators.

## Save time and money by doing your homework before meeting with a divorce professional

To save time and money, compile as much of the following information as you can before meeting with an attorney or other divorce professional:

- Each spouse's date of birth
- Names and birthdates of children, if you have any
- Date and place of marriage and length of time in present state
- Existence of prenuptial agreement
- Information about parties' prior marriages, children, etc.
- Date of separation and grounds for divorce
- Current occupation and name and address of employer for each spouse
- Social Security number for each spouse
- Income of each spouse
- Education, degrees, and training of each spouse
- Extent of employee benefits for each spouse
- Details of retirement plans for each spouse
- Joint assets of the parties
- Liabilities and debts of each spouse
- Life (and other) insurance of each spouse
- Separate or personal assets of each spouse, including trust funds and inheritances
- Financial records
- Family business records
- Collections, artwork, and antiques

If you're uncertain about some of these areas, you can obtain the necessary information through your spouse's financial affidavit



and/or the discovery process, both of which are mandated by the court.

## Consider the big questions, such as child custody and alimony

Although your divorce professional will help you work through the big issues, you might want to think about the following questions before meeting with him or her:

- If you have children, what are your wishes regarding custody, visitation, and child support?
- Whose health insurance plan should cover the children?
- Do you earn enough money to adequately support yourself, or should alimony be considered?
- Which assets do you really want, and which are you willing to let your spouse keep?
- How do you feel about the family home? Do you feel strongly about living there, or should it be sold or allotted to your spouse?
- Will you have enough money to pay the outstanding debt on whatever assets you keep?

In addition to an attorney, you may want to see a therapist to help you clarify your wishes, express yourself more clearly, and deal with any child-related issues. Such counseling is typically covered by health insurance.

## Some dos and don'ts when divorcing

Keep the following tips in mind:

- Do prepare a budget and a financial plan to sustain you until your divorce is final. Get help if you don't currently have the skills and energy to do this on your own.
- Do review monthly bank and financial statements and make copies for your attorney.
- Do review all tax returns that have been filed jointly or separately by your spouse.
- Do make sure all taxes have been paid to date.
- Do review the contents of any safe-deposit boxes.
- Do get emotional support for yourself--talk to friends, join a support group, or see a therapist.
- Don't make large purchases or create additional debt that might later cause financial hardship.
- Don't quit your job.
- Don't move out of the house before consulting your attorney.
- Don't transfer or give away assets that are owned jointly.
- Don't sign a blank financial statement or any other document without reviewing it with your attorney.



# Insurance Concerns of Divorcing Couples

Few life changes are of more consequence than a divorce. In addition to the financial and emotional difficulties, you'll face special concerns about your insurance coverage. Planning for these changes should begin long before the divorce is final. The selection of life and health insurance beneficiaries may have to be revised. If you have children, many of your insurance concerns will center on whether you are granted custody. And because it's common while married for one spouse to maintain health insurance for the family, the breakup of a marriage can have serious insurance consequences for the other spouse, especially if he or she was not employed outside the home.

## Protecting alimony and child support payments

The spouse given custody of the children (custodial parent) should make sure that the life of the noncustodial parent is insured. If you're the custodial parent, you don't want to end up in a position where child support payments suddenly end because your ex-spouse dies. The same thing applies to alimony payments. Life insurance can protect you and your children in case of untimely death. Some agreements require the noncustodial parent to pay for a policy on his or her life and to name the custodial parent as beneficiary. Your agreement should also state that you periodically receive proof that the policy is still in force.

### If you're the custodial parent

If you're receiving alimony or child support payments, purchasing a life insurance policy on your former spouse is the easiest way to protect yourself and your children. If you can't get new insurance on your former spouse, have his or her existing policies transferred to you as the new policyowner and beneficiary. This can be planned as part of the divorce agreement. Make certain that you are designated as the outright policyowner or as the irrevocable beneficiary. If you have trouble paying the policy premiums, you can petition the court to have alimony and child support payments increased to cover the cost of insurance. The court may even require your former spouse to pay the premiums. In this case, monitor the policy periodically to make sure that the payments are being made.

### If you're the noncustodial parent

Even though you don't have custody of your children, you'll want to ensure that they are protected financially. You may also have certain responsibilities to your former spouse. Insure your obligations by paying for a new policy on your life for the custodial parent. That way, you can keep any policies you currently have and protect your children's future at the same time. The policy can be given to your former spouse free from gift tax if given either before or as part of the divorce agreement. If the policy is entirely in your former spouse's name, any premiums you pay will likely be considered alimony for income tax purposes and are tax deductible. You should also insure the life of your former spouse. Remember that if he or she were to die, you would most likely gain custody of the children, increasing your expenses dramatically.

## Naming life insurance beneficiaries at divorce

Changing the beneficiary on a life insurance policy is as easy as calling up the insurer and requesting the appropriate paperwork. You can designate any person or entity to be the beneficiary, although some states require that the beneficiary have an insurable interest in your life (i.e., someone to whom you have a financial obligation). But during or after a divorce, your choices may be somewhat limited.

If a court has ordered, for instance, that you must continue an existing policy with your former spouse as beneficiary, you cannot change it. If you're under no such constraints, however, your choice usually boils down to either your estate, your ex-spouse, or your children. Designating your estate as beneficiary will tie up the insurance proceeds in probate. And unless you need to protect alimony or child support payments, you probably have no need or desire to name your ex-spouse. Designating your children as beneficiaries may be your best course, but doing so can be very complicated if they are minors. One solution is to create a trust for the children and name the trust as beneficiary.

*Note:* Divorce laws may differ from one state to the next, so consult an experienced legal professional before proceeding.

## Health insurance coverage and divorce





Often, one spouse participates in a group health insurance plan at work that provides coverage for both spouses. When a divorce occurs, coverage for the nonemployee spouse will often end, unless the divorce decree requires continuation of coverage. If there is no such requirement, temporary protection may be provided by the Consolidated Omnibus Budget Reconciliation Act (COBRA). This federal law protects employees of companies with 20 or more workers and their dependents from losing group insurance coverage as a result of job loss or divorce. Certain governmental and nonprofit enterprises are exempt. If your former spouse maintained family health coverage through work, you may (at your own expense) continue this group coverage for up to 36 months, or until you remarry or get coverage under another group health plan. Several states have enacted laws that may provide a former spouse with more generous rights than those under COBRA.

## **Disability income insurance and divorce**

If you receive alimony or child support, another risk to your income may arise if your former spouse becomes disabled. If he or she has no disability insurance and is unable to work, the court may modify the alimony and child support obligation, reducing or eliminating payments to you. With a disability policy, your ex-spouse will receive benefits each month and may be capable of paying the same amount of alimony and child support. Planning for disability insurance should be completed before the divorce is final. Unlike life insurance, you can't own a disability policy on someone else. So, the divorce decree may require that your ex-spouse pay the premiums on a policy and that you are entitled to regularly receive proof that the policy is in force.

## **Property insurance and divorce**

Real and personal property must be insured by the actual owner of the property (e.g., a car registered in your name must be owned by you). So, property insurance policies must be modified or rewritten to reflect the proper owner as the insured. Also, if a husband and a wife enter into an agreement covering their property rights, and divorce occurs within a specified period, all transfers of property are considered made for full consideration and are not subject to gift tax. With respect to married homeowners, the house can be sold immediately and the proceeds divided. Or, both spouses can continue to own the house jointly with a view toward a future sale. Another alternative is for one spouse to keep the house and buy out the other's interest. Or, the court may award the house to one spouse without trading assets while the title is held by both spouses. If the ownership is changed, a new deed should be drawn up to reflect the new arrangement, and the homeowners policy should be updated.

If you move into an apartment (even temporarily), you should buy renters insurance to cover your possessions.



# Health Insurance and Divorce

How will a divorce affect your health insurance coverage? During marriage, it's common for one spouse to maintain health coverage for the entire family through his or her group health insurance plan at work. After a divorce, coverage for the other spouse and the children could terminate. State and federal laws offer protection to families in danger of losing health-care coverage, especially to children. But it's important to re-examine your family's health insurance situation before a divorce occurs to avoid serious complications afterward.

## Health insurance coverage can be included in a divorce settlement

Because health coverage is such an important benefit, some divorce decrees stipulate that a spouse who provided health coverage for the other spouse or family during the marriage must continue to provide such coverage following a divorce. This is especially true if the other spouse didn't work outside the home and has no immediate access to health insurance. Neither an insurer nor an employer can deny such court-ordered coverage when children are involved.

If you're the spouse who carries the health coverage, you may have to pay additional premiums to continue coverage for your ex-spouse and your children, depending on the policy provisions. Some group policies will routinely allow you to continue full coverage for your family even after your divorce. Of course, this may change if you later remarry and want to include your new family on your policy. In any case, the premium for a group family plan may be less expensive than single coverage for two adults.

## If your family has individual health insurance

If the issue of health insurance is not included in your divorce settlement, you'll need to do some scrambling around if your ex-spouse is the insured on the family's individual health insurance policy. It's very possible that the coverage provided to you and your children could be terminated. Talk to your insurance agent to determine if you're still covered, and for how long. If you're still included in the policy, find out how much the premiums will be over the next 6 to 12 months. Also, begin looking into new health insurance for you and your children.

## Secure health coverage for your children

Hopefully, you and your former spouse can work out an agreement regarding health coverage for your children. The child support section of the divorce agreement assigns responsibility for providing the children's health insurance. But if the noncustodial parent or that parent's insurance company or employer refuses to cooperate, federal law provides for a court order that secures your children's continued health insurance coverage. This court order, known as a Qualified Medical Child Support Order (QMCSO), stipulates that custodial parents have the right to obtain health insurance coverage for their children through the noncustodial parent's group health plan, if the noncustodial parent has such coverage. The children can't be denied access to the plan, although limitations can be placed on the coverage. The order will not require the plan to provide additional benefits not actually offered in the plan.

The QMCSO can require that policy premiums be deducted directly out of the employee's paycheck. Reimbursements for medical care are made directly to the custodial (nonemployee) parent, when that parent pays a provider. Also, the noncustodial parent can't choose a medical plan that is unsuitable for the children. If you're the custodial parent, get copies of your ex-spouse's medical plan, medical claims and election forms, the summary plan description outlining your former spouse's employee benefits, and the page designating the current insureds of the health plan.

## Temporary coverage through your former spouse's employer

Temporary protection may be available through the Consolidated Omnibus Budget Reconciliation Act (COBRA). This federal law was designed to protect employees and their dependents at companies with 20 or more workers from losing group insurance coverage as a result of job loss or divorce.

If your former spouse maintained family health coverage through work, you may (at your own expense) continue this group coverage for up to 36 months after the divorce or legal separation. Your cost of continuing COBRA coverage can't exceed 102 percent of the cost to the plan for providing identical benefits to an active participant. Be aware that you have the right to pay the premiums in monthly installments. Also, you must pay premiums on time or you'll lose your coverage. COBRA coverage will terminate sooner than 36 months if you remarry or obtain coverage under another group health plan. Certain governmental plans



and church-sponsored plans are exempt from the act.

Several states have enacted their own laws that preserve a spouse's eligibility for health insurance after a separation or divorce. Some of these laws may provide you with rights more generous than those offered under COBRA, so check your state's laws first. Ask your divorce attorney or contact your state insurance commissioner's office.

Also, if you're over a certain age, it may be wise to purchase individual health insurance or to make sure your working former spouse maintains health coverage as part of the divorce settlement. Otherwise, when COBRA coverage terminates after 36 months, you may find that poor health in your later years presents an insurability problem or that the cost of coverage is exorbitant. In addition, the Health Insurance Portability and Accountability Act of 1996 may provide certain protection regarding pre-existing conditions.



# Life Insurance at Various Life Stages

Your need for life insurance changes as your life changes. When you're young, you typically have less need for life insurance, but that changes as you take on more responsibility and your family grows. Then, as your responsibilities once again begin to diminish, your need for life insurance may decrease. Let's look at how your life insurance needs change throughout your lifetime.

## Footloose and fancy-free

As a young adult, you become more independent and self-sufficient. You no longer depend on others for your financial well-being. But in most cases, your death would still not create a financial hardship for others. For most young singles, life insurance is not a priority.

Some would argue that you should buy life insurance now, while you're healthy and the rates are low. This may be a valid argument if you are at a high risk for developing a medical condition (such as diabetes) later in life. But you should also consider the earnings you could realize by investing the money now instead of spending it on insurance premiums.

If you have a mortgage or other loans that are jointly held with a cosigner, your death would leave the cosigner responsible for the entire debt. You might consider purchasing enough life insurance to cover these debts in the event of your death. Funeral expenses are also a concern for young singles, but it is typically not advisable to purchase a life insurance policy just for this purpose, unless paying for your funeral would burden your parents or whomever would be responsible for funeral expenses. Instead, consider investing the money you would have spent on life insurance premiums.

Your life insurance needs increase significantly if you are supporting a parent or grandparent, or if you have a child before marriage. In these situations, life insurance could provide continued support for your dependent(s) if you were to die.

## Going to the chapel

Married couples without children typically still have little need for life insurance. If both spouses contribute equally to household finances and do not yet own a home, the death of one spouse will usually not be financially catastrophic for the other.

Once you buy a house, the situation begins to change. Even if both spouses have well-paying jobs, the burden of a mortgage may be more than the surviving spouse can afford on a single income. Credit card debt and other debts can contribute to the financial strain.

To make sure either spouse could carry on financially after the death of the other, both of you should probably purchase a modest amount of life insurance. At a minimum, it will provide peace of mind knowing that both you and your spouse are protected.

Again, your life insurance needs increase significantly if you are caring for an aging parent, or if you have children before marriage. Life insurance becomes extremely important in these situations, because these dependents must be provided for in the event of your death.

## Your growing family

When you have young children, your life insurance needs reach a climax. In most situations, life insurance for both parents is appropriate.

Single-income families are completely dependent on the income of the breadwinner. If he or she dies without life insurance, the consequences could be disastrous. The death of the stay-at-home spouse would necessitate costly day-care and housekeeping expenses. Both spouses should carry enough life insurance to cover the lost income or the economic value of lost services that would result from their deaths.

Dual-income families need life insurance, too. If one spouse dies, it is unlikely that the surviving spouse will be able to keep up with the household expenses and pay for child care with the remaining income.

## Moving up the ladder

For many people, career advancement means starting a new job with a new company. At some point, you might even decide to



be your own boss and start your own business. It's important to review your life insurance coverage any time you leave an employer.

Keep in mind that when you leave your job, your employer-sponsored group life insurance coverage will usually end, so find out if you will be eligible for group coverage through your new employer, or look into purchasing life insurance coverage on your own. You may also have the option of converting your group coverage to an individual policy. This may cost significantly more, but may be wise if you have a pre-existing medical condition that may prevent you from buying life insurance coverage elsewhere.

Make sure that the amount of your coverage is up-to-date, as well. The policy you purchased right after you got married might not be adequate anymore, especially if you have kids, a mortgage, and college expenses to consider. Business owners may also have business debt to consider. If your business is not incorporated, your family could be responsible for those bills if you die.

## Single again

If you and your spouse divorce, you'll have to decide what to do about your life insurance. Divorce raises both beneficiary issues and coverage issues. And if you have children, these issues become even more complex.

If you and your spouse have no children, it may be as simple as changing the beneficiary on your policy and adjusting your coverage to reflect your newly single status. However, if you have kids, you'll want to make sure that they, and not your former spouse, are provided for in the event of your death. This may involve purchasing a new policy if your spouse owns the existing policy, or simply changing the beneficiary from your spouse to your children. The custodial and noncustodial parent will need to work out the details of this complicated situation. If you can't come to terms, the court will make the decisions for you.

## Your retirement years

Once you retire, and your priorities shift, your life insurance needs may change. If fewer people are depending on you financially, your mortgage and other debts have been repaid, and you have substantial financial assets, you may need less life insurance protection than before. But it's also possible that your need for life insurance will remain strong even after you retire. For example, the proceeds of a life insurance policy can be used to pay your final expenses or to replace any income lost to your spouse as a result of your death (e.g., from a pension or Social Security). Life insurance can be used to pay estate taxes or leave money to charity.



# Life Insurance Basics

Life insurance is an agreement between you (the policy owner) and an insurer. Under the terms of a life insurance policy, the insurer promises to pay a certain sum to a person you choose (your beneficiary) upon your death, in exchange for your premium payments. Proper life insurance coverage should provide you with peace of mind, since you know that those you care about will be financially protected after you die.

## The many uses of life insurance

One of the most common reasons for buying life insurance is to replace the loss of income that would occur in the event of your death. When you die and your paychecks stop, your family may be left with limited resources. Proceeds from a life insurance policy make cash available to support your family almost immediately upon your death. Life insurance is also commonly used to pay any debts that you may leave behind. Life insurance can be used to pay off mortgages, car loans, and credit card debts, leaving other remaining assets intact for your family. Life insurance proceeds can also be used to pay for final expenses and estate taxes. Finally, life insurance can create an estate for your heirs.

## How much life insurance do you need?

Your life insurance needs will depend on a number of factors, including whether you're married, the size of your family, the nature of your financial obligations, your career stage, and your goals. For example, when you're young, you may not have a great need for life insurance. However, as you take on more responsibilities and your family grows, your need for life insurance increases.

There are plenty of tools to help you determine how much coverage you should have. Your best resource may be a financial professional. At the most basic level, the amount of life insurance coverage that you need corresponds directly to your answers to these questions:

- What immediate financial expenses (e.g., debt repayment, funeral expenses) would your family face upon your death?
- How much of your salary is devoted to current expenses and future needs?
- How long would your dependents need support if you were to die tomorrow?
- How much money would you want to leave for special situations upon your death, such as funding your children's education, gifts to charities, or an inheritance for your children?

Since your needs will change over time, you'll need to continually re-evaluate your need for coverage.

## How much life insurance can you afford?

How do you balance the cost of insurance coverage with the amount of coverage that your family needs? Just as several variables determine the amount of coverage that you need, many factors determine the cost of coverage. The type of policy that you choose, the amount of coverage, your age, and your health all play a part. The amount of coverage you can afford is tied to your current and expected future financial situation, as well. A financial professional or insurance agent can be invaluable in helping you select the right insurance plan.

## What's in a life insurance contract?

A life insurance contract is made up of legal provisions, your application (which identifies who you are and your medical declarations), and a policy specifications page that describes the policy you have selected, including any options and riders that you have purchased in return for an additional premium.

Provisions describe the conditions, rights, and obligations of the parties to the contract (e.g., the grace period for payment of premiums, suicide and incontestability clauses).

The policy specifications page describes the amount to be paid upon your death and the amount of premiums required to keep the policy in effect. Also stated are any riders and options added to the standard policy. Some riders include the waiver of premium rider, which allows you to skip premium payments during periods of disability; the guaranteed insurability rider, which permits you to raise the amount of your insurance without a further medical exam; and accidental death benefits.



The insurer may add an endorsement to the policy at the time of issue to amend a provision of the standard contract.

## Types of life insurance policies

The two basic types of life insurance are term life and permanent (cash value) life. Term policies provide life insurance protection for a specific period of time. If you die during the coverage period, your beneficiary receives the policy death benefit. If you live to the end of the term, the policy simply terminates, unless it automatically renews for a new period. Term policies are available for periods of 1 to 30 years or more and may, in some cases, be renewed until you reach age 95. Premium payments may be increasing, as with annually renewable 1-year (period) term, or level (equal) for up to 30-year term periods.

Permanent insurance policies provide protection for your entire life, provided you pay the premium to keep the policy in force. Premium payments are greater than necessary to provide the life insurance benefit in the early years of the policy, so that a reserve can be accumulated to make up the shortfall in premiums necessary to provide the insurance in the later years. Should the policyowner discontinue the policy, this reserve, known as the cash value, is returned to the policyowner. Permanent life insurance can be further broken down into the following basic categories:

- **Whole life:** You generally make level (equal) premium payments for life. The death benefit and cash value are predetermined and guaranteed. Any guarantees associated with payment of death benefits, income options, or rates of return are based on the claims-paying ability of the insurer.
- **Universal life:** You may pay premiums at any time, in any amount (subject to certain limits), as long as policy expenses and the cost of insurance coverage are met. The amount of insurance coverage can be decreased, and the cash value will grow at a declared interest rate, which may vary over time.
- **Index universal life:** This is a form of universal life insurance with excess interest credited to cash values. But, unlike universal life insurance, the amount of interest credited is tied to the performance of an equity index, such as the S&P 500.
- **Variable life:** As with whole life, you pay a level premium for life. However, the death benefit and cash value fluctuate depending on the performance of investments in what are known as subaccounts. A subaccount is a pool of investor funds professionally managed to pursue a stated investment objective. The policyowner selects the subaccounts in which the cash value should be invested.
- **Variable universal life:** A combination of universal and variable life. You may pay premiums at any time, in any amount (subject to limits), as long as policy expenses and the cost of insurance coverage are met. The amount of insurance coverage can be decreased, and the cash value goes up or down based on the performance of investments in the subaccounts.

**Note:** *Variable life and variable universal life insurance policies are offered by prospectus, which you can obtain from your financial professional or the insurance company. The prospectus contains detailed information about investment objectives, risks, charges, and expenses. You should read the prospectus and consider this information carefully before purchasing a variable life or variable universal life insurance policy.*

## Your beneficiaries

You must name a primary beneficiary to receive the proceeds of your insurance policy. You may name a contingent beneficiary to receive the proceeds if your primary beneficiary dies before the insured. Your beneficiary may be a person, corporation, or other legal entity. You may name multiple beneficiaries and specify what percentage of the net death benefit each is to receive. You should carefully consider the ramifications of your beneficiary designations to ensure that your wishes are carried out as you intend.

Generally, you can change your beneficiary at any time. Changing your beneficiary usually requires nothing more than signing a new designation form and sending it to your insurance company. If you have named someone as an irrevocable (permanent) beneficiary, however, you will need that person's permission to adjust any of the policy's provisions.

## Where can you buy life insurance?

You can often get insurance coverage from your employer (i.e., through a group life insurance plan offered by your employer) or through an association to which you belong (which may also offer group life insurance). You can also buy insurance through a licensed life insurance agent or broker, or directly from an insurance company.

Any policy that you buy is only as good as the company that issues it, so investigate the company offering you the insurance. Ratings services, such as A. M. Best, Moody's, and Standard & Poor's, evaluate an insurer's financial strength. The company



offering you coverage should provide you with this information.





# Establishing a Budget

Do you ever wonder where your money goes each month? Does it seem like you're never able to get ahead? If so, you may want to establish a budget to help you keep track of how you spend your money and help you reach your financial goals.

## Examine your financial goals

Before you establish a budget, you should examine your financial goals. Start by making a list of your short-term goals (e.g., new car, vacation) and your long-term goals (e.g., your child's college education, retirement). Next, ask yourself: How important is it for me to achieve this goal? How much will I need to save? Armed with a clear picture of your goals, you can work toward establishing a budget that can help you reach them.

## Identify your current monthly income and expenses

To develop a budget that is appropriate for your lifestyle, you'll need to identify your current monthly income and expenses. You can jot the information down with a pen and paper, or you can use one of the many software programs available that are designed specifically for this purpose.

Start by adding up all of your income. In addition to your regular salary and wages, be sure to include other types of income, such as dividends, interest, and child support. Next, add up all of your expenses. To see where you have a choice in your spending, it helps to divide them into two categories: fixed expenses (e.g., housing, food, clothing, transportation) and discretionary expenses (e.g., entertainment, vacations, hobbies). You'll also want to make sure that you have identified any out-of-pattern expenses, such as holiday gifts, car maintenance, home repair, and so on. To make sure that you're not forgetting anything, it may help to look through canceled checks, credit card bills, and other receipts from the past year. Finally, as you list your expenses, it is important to remember your financial goals. Whenever possible, treat your goals as expenses and contribute toward them regularly.

## Evaluate your budget

Once you've added up all of your income and expenses, compare the two totals. To get ahead, you should be spending less than you earn. If this is the case, you're on the right track, and you need to look at how well you use your extra income. If you find yourself spending more than you earn, you'll need to make some adjustments. Look at your expenses closely and cut down on your discretionary spending. And remember, if you do find yourself coming up short, don't worry! All it will take is some determination and a little self-discipline, and you'll eventually get it right.

## Monitor your budget

You'll need to monitor your budget periodically and make changes when necessary. But keep in mind that you don't have to keep track of every penny that you spend. In fact, the less record keeping you have to do, the easier it will be to stick to your budget. Above all, be flexible. Any budget that is too rigid is likely to fail. So be prepared for the unexpected (e.g., leaky roof, failed car transmission).

## Tips to help you stay on track

- Involve the entire family: Agree on a budget up front and meet regularly to check your progress
- Stay disciplined: Try to make budgeting a part of your daily routine
- Start your new budget at a time when it will be easy to follow and stick with the plan (e.g., the beginning of the year, as opposed to right before the holidays)
- Find a budgeting system that fits your needs (e.g., budgeting software)
- Distinguish between expenses that are "wants" (e.g., designer shoes) and expenses that are "needs" (e.g., groceries)
- Build rewards into your budget (e.g., eat out every other week)
- Avoid using credit cards to pay for everyday expenses: It may seem like you're spending less, but your credit card debt will continue to increase



# Choosing a Beneficiary for Your IRA or 401(k)

Selecting beneficiaries for retirement benefits is different from choosing beneficiaries for other assets such as life insurance. With retirement benefits, you need to know the impact of income tax and estate tax laws in order to select the right beneficiaries. Although taxes shouldn't be the sole determining factor in naming your beneficiaries, ignoring the impact of taxes could lead you to make an incorrect choice.

In addition, if you're married, beneficiary designations may affect the size of minimum required distributions to you from your IRAs and retirement plans while you're alive.

## Paying income tax on most retirement distributions

Most inherited assets such as bank accounts, stocks, and real estate pass to your beneficiaries without income tax being due. However, that's not usually the case with 401(k) plans and IRAs.

Beneficiaries pay ordinary income tax on distributions from pretax 401(k) accounts and traditional IRAs. With Roth IRAs and Roth 401(k) accounts, however, your beneficiaries can receive the benefits free from income tax if all of the tax requirements are met. That means you need to consider the impact of income taxes when designating beneficiaries for your 401(k) and IRA assets.

For example, if one of your children inherits \$100,000 cash from you and another child receives your pretax 401(k) account worth \$100,000, they aren't receiving the same amount. The reason is that all distributions from the 401(k) plan will be subject to income tax at ordinary income tax rates, while the cash isn't subject to income tax when it passes to your child upon your death.

Similarly, if one of your children inherits your taxable traditional IRA and another child receives your income-tax-free Roth IRA, the bottom line is different for each of them.

## Naming or changing beneficiaries

When you open up an IRA or begin participating in a 401(k), you are given a form to complete in order to name your beneficiaries. Changes are made in the same way--you complete a new beneficiary designation form. A will or trust does not override your beneficiary designation form. However, spouses may have special rights under federal or state law.

It's a good idea to review your beneficiary designation form at least every two to three years. Also, be sure to update your form to reflect changes in financial circumstances. Beneficiary designations are important estate planning documents. Seek legal advice as needed.

## Designating primary and secondary beneficiaries

When it comes to beneficiary designation forms, you want to avoid gaps. If you don't have a named beneficiary who survives you, your estate may end up as the beneficiary, which is not always the best result.

Your primary beneficiary is your first choice to receive retirement benefits. You can name more than one person or entity as your primary beneficiary. If your primary beneficiary doesn't survive you or decides to decline the benefits (the tax term for this is a disclaimer), then your secondary (or "contingent") beneficiaries receive the benefits.

## Having multiple beneficiaries

You can name more than one beneficiary to share in the proceeds. You just need to specify the percentage each beneficiary will receive (the shares do not have to be equal). You should also state who will receive the proceeds should a beneficiary not survive you.

In some cases, you'll want to designate a different beneficiary for each account or have one account divided into subaccounts (with a beneficiary for each subaccount). You'd do this to allow each beneficiary to use his or her own life expectancy in calculating required distributions after your death. This, in turn, can permit greater tax deferral (delay) and flexibility for your beneficiaries in paying income tax on distributions.

## Avoiding gaps or naming your estate as a beneficiary



There are two ways your retirement benefits could end up in your probate estate. Probate is the court process by which assets are transferred from someone who has died to the heirs or beneficiaries entitled to those assets.

First, you might name your estate as the beneficiary. Second, if no named beneficiary survives you, your probate estate may end up as the beneficiary by default. If your probate estate is your beneficiary, several problems can arise.

If your estate receives your retirement benefits, the opportunity to maximize tax deferral by spreading out distributions may be lost. In addition, probate can mean paying attorney's and executor's fees and delaying the distribution of benefits.

## **Naming your spouse as a beneficiary**

When it comes to taxes, your spouse is usually the best choice for a primary beneficiary.

A spousal beneficiary has the greatest flexibility for delaying distributions that are subject to income tax. In addition to rolling over your 401(k) or IRA to his or her IRA or plan, a surviving spouse can generally decide to treat your IRA as his or her own IRA. These options can provide more tax and planning options.

If your spouse is more than 10 years younger than you, then naming your spouse can also reduce the size of any required taxable distributions to you from retirement assets while you're alive. This can allow more assets to stay in the retirement account longer and delay the payment of income tax on distributions.

Although naming a surviving spouse can produce the best income tax result, that isn't necessarily the case with death taxes. At your death, your spouse can inherit an unlimited amount of assets and defer federal death tax until both of you are deceased (note: special tax rules and requirements apply for a surviving spouse who is not a U.S. citizen). If your spouse's taxable estate for federal tax purposes at his or her death exceeds the applicable exclusion amount, then federal death tax may be due. In other words, one possible downside to naming your spouse as the primary beneficiary is that it may increase the size of your spouse's estate for death tax purposes, which in turn may result in death tax or increased death tax when your spouse dies.

## **Naming other individuals as beneficiaries**

You may have some limits on choosing beneficiaries other than your spouse. No matter where you live, federal law dictates that your surviving spouse be the primary beneficiary of your 401(k) plan benefit unless your spouse signs a timely, effective written waiver. And if you live in one of the community property states, your spouse may have rights related to your IRA regardless of whether he or she is named as the primary beneficiary.

Keep in mind that a nonspouse beneficiary cannot roll over your 401(k) or IRA to his or her own IRA. However, a nonspouse beneficiary can directly roll over all or part of your 401(k) benefits to an inherited IRA.

## **Naming a trust as a beneficiary**

You must follow special tax rules when naming a trust as a beneficiary, and there may be income tax complications. Seek legal advice before designating a trust as a beneficiary.

## **Naming a charity as a beneficiary**

In general, naming a charity as the primary beneficiary will not affect required distributions to you during your lifetime. However, after your death, having a charity named with other beneficiaries on the same asset could affect the tax-deferral possibilities of the noncharitable beneficiaries, depending on how soon after your death the charity receives its share of the benefits.



# Choosing an Income Tax Filing Status

Selecting a filing status is one of the first decisions you'll make when you fill out your federal income tax return, so it's important to know the rules. And because you may have more than one option, you need to know the advantages and disadvantages of each. Making the right decision about your filing status can save money and prevent problems with the IRS down the road.

## The five filing statuses and how they affect your tax liability

Your filing status is especially important because it determines, in part, the tax rate applied to your taxable income, the amount of your standard deduction, and the types of deductions and credits available. By choosing the right filing status, you can minimize your taxes.

The five filing statuses are single, married filing jointly, married filing separately, head of household, and qualifying widow(er) with dependent child. There are seven income tax brackets for 2016. Your tax rate depends on your filing status and the amount of your taxable income. For example, if you're single and your taxable income is more than \$9,275 but not more than \$37,650 (in 2016), it's taxed at a top rate of 15 percent. If you're a head of household filer, though, your taxable income can climb to \$50,400 and still be taxed at a top rate of 15 percent. So, some filing statuses are more beneficial than others.

Although you'll generally want to choose whichever filing status minimizes your taxes, other considerations (such as a pending divorce) may also come into play.

## You're single if you're unmarried or legally separated from your spouse on the last day of the year

This one's pretty straightforward. And, depending on your circumstances, it may be your only option. Your filing status is determined as of the last day of the tax year (December 31). To use the single status, you must be unmarried or separated from your spouse by either divorce or a written separate maintenance decree on the last day of the year.

## Married filing jointly may result in tax savings for married couples

You may file jointly if, on the last day of the tax year, you are:

- Married and living together
- Married and living apart, but not legally separated under a divorce decree or separate maintenance agreement, or
- Separated under an interlocutory (i.e., not final) decree of divorce

Also, you are considered married for the entire tax year for filing status purposes if your spouse died during the tax year.

When filing jointly, you and your spouse combine your income, exemptions, deductions, and credits. Filing jointly generally offers the most tax savings for married couples. For one thing, there are many credits that you can take if you file a joint return that you can't take if you file married filing separately. These include the child and dependent care credit, the adoption expense credit, the American Opportunity credit (the Hope credit), and the Lifetime Learning credit.

Still, this filing status is not always the most advantageous. If your spouse owes certain debts (including defaulted student loans and unpaid child support), the IRS may divert any refund due on your joint tax return to the appropriate agency. To get your share of the refund, you'll have to file an injured spouse claim. You can avoid the hassle by filing a separate return.

## You don't have to be separated to choose married filing separately

You and your spouse can choose to file separately if you're married as of the last day of the tax year. Here, you'd report only your own income and claim only your own deductions and credits. Filing separately may be wise if you want to be responsible only for your own tax. With a joint return, by comparison, each spouse is jointly and individually liable for the full amount of the tax due. So, if your spouse skips town, you'd be left holding the tax bag unless you qualified as an innocent spouse.

Filing separately might also be the best tax move if one spouse has significant medical expenses or miscellaneous itemized deductions. Your ability to take these deductions is tied in to the level of your adjusted gross income (AGI). For example, medical



expenses are generally deductible only if they exceed 10 percent of your AGI (the AGI threshold was 7.5 percent for tax years prior to 2013, and the 7.5 percent threshold still applies through 2016 if either you or your spouse is age 65 or older by the end of the tax year). By filing separately, the AGI for each spouse is reduced. Keep in mind that if you and your spouse file separately and your spouse itemizes deductions, you'll have to do the same.

Remember, though, that you won't qualify for certain credits (such as the child and dependent care tax credit) and can't take certain deductions if you file separately. For example, you cannot deduct qualified education loan interest if you're married, unless you file a joint return.

## Head of household status offers certain income tax advantages

Those who qualify for the head of household filing status get special tax treatment. Not only are the tax rate thresholds higher for head of household filers than for single filers and married filing separately filers, but the standard deduction is larger as well. However, you'll have to satisfy the following requirements:

- Generally, you should be unmarried at the end of the year (unless you live apart from your spouse and meet certain tests)
- You must maintain a household for your child, dependent parent, or other qualifying dependent relative
- The household must be your home and generally must also be the main home of a qualifying relative for more than half of the year
- You must provide more than half the cost of maintaining the household
- You must be a U.S. citizen or resident alien for the entire tax year

## Qualifying widow(er) with dependent child offers the advantages of a joint return

You may be able to select the qualifying widow(er) with dependent child filing status if your spouse died recently. This status allows you to use joint tax rates and offers the highest possible standard deduction, the one applicable to joint tax returns. To qualify, you must satisfy all of the following conditions:

- Your spouse died either last tax year or the tax year before that
- You qualified to file a joint return with your spouse for the year he or she died
- You have not remarried before the end of the tax year
- You have a qualifying dependent child
- You provide over half the cost of keeping up a home for yourself and your qualifying child

As you can see, choosing the correct filing status is not always easy. You might want to speak with a tax professional or consult IRS Publication 17 for more information.



# Planning Concerns of Divorcing Couples

## Why is it important for you to understand the basics of divorce law?

While divorce is certainly a time of emotional turmoil, it's a time of financial upheaval as well. The financial change brought about by divorce can be particularly devastating to families with children and to older couples who have assigned the career duties to one spouse and the homemaking duties to the other.

When seeking a divorce, you should become familiar with the major topics: legal fees, marital property versus separate property, alimony, debt, retirement plans, property settlement, taxation, budgeting, and, if you have children, child custody and child support. You should also consider risk management, and, if you're older, Social Security.

By becoming knowledgeable about these areas, you can provide your attorney (if any) with a complete and accurate outline of your wishes regarding the divorce settlement, and you will be able to make an informed decision before signing your divorce agreement.

## What do you need to know about legal fees?

When seeking a divorce, you'll want to consider whether a simple, amicable arrangement is likely or whether attorneys should be hired. If you wish to hire an attorney, you should note that divorce attorneys typically charge hourly rates and require you to submit retainers (lump sums) up front. Rates can vary, depending on the complexity of the case, the reputation and experience of the divorce attorney, and the geographic location.

If you're a financially dependent spouse (such as a homemaker), it's possible for a court to award sufficient legal fees and costs to enable you to retain competent counsel. Upon your submission of an appropriate motion to the court, a judge could order your spouse to subsidize your legal fees for the divorce.

You should also consider the deductibility of divorce expenses. In general, most legal fees and court costs for obtaining a divorce are considered personal expenses and aren't deductible for income tax purposes. However, you may deduct as a miscellaneous deduction on IRS Schedule A, subject to the 2 percent floor, any money paid for advice related to the tax consequences of your divorce or securing income. Specifically, deductible items include fees for advice on securing and collecting alimony and the tax consequences of property and payments received. On your legal bill, your attorney should make a reasonable allocation of the legal expenses between tax-related (deductible) and non-tax-related (nondeductible) advice.

## How is property classified for divorce purposes?

Assets are divided in accordance with state law, so it makes a difference whether you live in a community property state (presently Alaska (which has an optional system), Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, and Wisconsin) or Puerto Rico, or an equitable division state. Within these two categories of states, property may be classified as either separate property or marital property, but again, these definitions will vary depending on your state. Therefore, it's important for you to know how your state classifies property. For example, one state may mandate that separate property consist of gifts, inheritances, and property owned prior to the marriage, and that such items will not be divided between the spouses in the event of a divorce. Another state may proclaim that all property owned by the couple is marital property, subject to division at divorce--it doesn't matter who inherited what.

## What should you know about child custody, child support, and alimony?

When parents separate and divorce, one of the most emotionally charged issues involves the decision regarding who will live with the children. Determining the extent of child support, and possibly the necessity for enforcement of child support payments, is also cause for stress.

Child custody is based on a number of factors. Most judges place primary importance on the best interests of the children.



Custody may be classified as physical or legal, and can be awarded to one or both parents.

Most states have child support guidelines for determining the amount of child support to be paid. Child support orders can be modified when there's a substantial change in circumstances, and most states provide a number of methods for collecting unpaid support.

Alimony is also an important topic, particularly to spouses with custody of minor children and to older homemakers. Alimony is based on one party's need and the other's ability to pay. Deciding whether a spouse should receive alimony (and, if so, how much) is based on certain criteria, which can vary from state to state.

## What should you know about property division?

Property division is a complex area, encompassing such subtopics as the marital residence , debt , and retirement plans and QDROs.

It also involves a number of other areas as well, including: classification and valuation of property, hidden assets, family businesses, and structuring property settlements.

## What should you know about taxation?

If you're legally separated or divorced, it's important to become familiar with the applicable tax rules regarding filing status, dependent children, alimony, and property disposition. Indeed, understanding the tax implications of your initial preferences regarding child custody and property settlement may alter or influence your final decisions..

## What should you know about budgeting and finances?

During the divorce process, both spouses must determine and disclose their monthly income and expense needs. Claims for support (based on need and an evaluation of the other party's ability to pay) are based on this financial affidavit.

It's not uncommon in a marriage for one spouse to assume primary responsibility for the family budget. For some couples, bills are paid when due, but neither party tries to stick to a budget. When two households are created incident to a divorce, cash becomes tighter and it becomes necessary to develop a budget. A number of tools can be used for this purpose.

## Do you need to know about risk management and Social Security?

Risk management should certainly be considered when a divorce seems likely. The selection of beneficiaries for your life insurance policy will probably be revised, and, in some cases, your health insurance coverage may terminate. Often, for example, one spouse participates in a group health insurance plan at work that provides coverage for both spouses. When a divorce occurs, coverage for the nonemployee spouse may end. You need to know what your health insurance options are and how life, disability, and property insurance should factor into your divorce agreement.

Social Security may be an issue if you're an older individual seeking a divorce after a long-term marriage. Be aware that, if you've been married to your spouse for at least 10 years, you may (in certain cases) be able to qualify for Social Security benefits based on your spouse's record, even after you divorce.

## What information should you gather before consulting with an attorney?

Before sitting down with an attorney to commence a divorce, go through the following list to make sure you provide all relevant information:

- Your name, address, telephone number
- Spouse's name, address, telephone number
- Each spouse's date of birth
- Names and birth dates of children
- Date and place of marriage and length of time in present state



- Existence of prenuptial agreement
- Information about parties' prior marriages, children, etc.
- Date of separation and grounds for divorce
- Current occupation and name and address of employer (both parties)
- Social Security number of both parties
- Income of each party
- Education, degrees, and training of each party
- Extent of employee benefits for each party
- Details of retirement plans for each party
- Joint assets of the parties, including:
  1. House
  2. Other real estate
  3. Stocks, bonds, and securities
  4. Bank accounts
  5. Individual retirement accounts (IRAs), and
  6. Boats and other assets
- Liabilities and debts of each party
- Life and other insurance of each party
- Separate or personal assets of each party, including trust funds and inheritances
- Financial records, including:
  1. Bank statements
  2. Tax returns
  3. Loan applications, and
  4. Investment statements
- Family business records, including:
  1. Type of business
  2. Shareholders
  3. Percentage of ownership
  4. Bank statements of business
  5. Tax returns of business
  6. Applications for loans
  7. Income and balance sheets
  8. Financial reports, and
  9. Buy-sell agreements
- Collections, artwork, and antiques

Obviously, you won't have all of the above information and documentation at your fingertips. Provide whatever you can. The rest can be ascertained during the divorce discovery process. You'll need to think about a few other questions as well once you've provided your attorney with the basic checklist of information. Consider the following:

- Which assets do you really want, and which are you willing to assign to your spouse?
- How do you feel about the family home? Do you feel strongly about living there, or should it be sold or allotted to your spouse?
- With respect to the children (if any), what are your wishes regarding custody, visitation, and child support?
- Do you earn enough money to adequately support yourself, or should alimony be considered?
- Will you have sufficient liquidity to pay the debt on whatever assets you keep?
- What are the income tax consequences of your decisions regarding property disposition?
- Regarding a family business, does your state value assets at the time of separation, settlement, divorce, or some other time?





Discuss these and any other questions with your attorney.



# Divorce and Estate Planning

## How does divorce affect estate planning?

Wills for both spouses are often drawn up sometime during the marriage--particularly if there are children involved. When divorce is contemplated, the selection of beneficiaries and executors will likely be revised to reflect the absence of your former spouse. Additionally, you will need to re-examine the gift and estate tax aspects of your estate plan. For these reasons, many divorcing couples revise their estate planning documents during the period of separation or soon after the divorce has been finalized.

## What should you be concerned about during the separation period?

If divorce proceedings have begun, it's important to draft a formal separation agreement as soon as possible, establishing the spouses' rights regarding property, debts, temporary alimony, child support, and child custody. When drafting the provisions, you (or your attorney) will want to consider the possibility of your spouse dying prior to entry of the final divorce decree. You may wish to make the agreement binding on heirs and assigns so that the obligations will continue if one party dies.

If you expect to receive alimony and child support from your spouse, you may want to require (in the separation agreement) that your spouse buy a life insurance policy (or keep the existing one in force), naming you as the beneficiary. The policy should be in an amount sufficient to cover the sum of support obligations and property distribution payments contemplated. You could even be named as the owner of the policy insuring your spouse's life.

Similarly, your agreement might require your spouse to maintain minimum will provisions in favor of you (and/or your children). Often, the parties to a separation agreement include a provision that both waive the right to elect a share of the estate of the other in the event that one party dies before the divorce decree is entered.

## When revising your estate plan, which areas require particular note?

First of all, you should make the necessary changes in your will or other estate planning documents to ensure that your former spouse isn't named as your personal representative, successor trustee, beneficiary, or holder of the power of attorney. A new will will likely be drafted during the separation period. Note that in some states, wills drawn up during a marriage are considered void after a divorce unless specifically ratified after the divorce. This means that intestacy rules would apply, instead of the will being controlling.

Next, consider gift tax implications if funding your children's education is required by your property settlement. Although your direct tuition payments (even for adult children) are exempt from gift tax when required by a property settlement agreement, be aware that your payments for related educational expenses (e.g., books and room and board) may be subject to gift tax.

**Example(s):** *Liz and Frank have a daughter, Carol. Carol has reached the age of majority under state law. When the couple divorced, Frank agreed (as part of the settlement) to pay for Carol's college tuition, books, room, and board. During the year, Frank pays \$20,000 tuition directly to Carol's university, and he gives Carol \$15,000 in cash for living expenses. The tuition isn't a taxable gift, but the \$15,000 in cash will be treated as a taxable gift.*

Finally, consider the absence of the unlimited marital deduction. A deduction is allowed for qualifying transfers to one's spouse during lifetime or at death. Because this gift and estate tax deduction is one of the most important estate planning tools for married couples, your loss of this tool at divorce can affect your tax situation adversely when you die.



# Divorce and Social Security

## How does divorce affect Social Security retirement benefits?

After a divorce, you can claim retirement benefits based on your own earnings record (if you have been employed and have accumulated enough credits over the years), or you can claim benefits based on your ex-spouse's earnings record (whether or not you ever worked), provided that certain requirements are met.

## What requirements must be met?

You may qualify for benefits based on your ex-spouse's earnings record if all of the following conditions are met:

- Your ex-spouse is currently entitled to receive Social Security retirement or disability benefits
- You and your ex-spouse were married for at least 10 years before the divorce became final
- You are not currently married
- You are age 62 or older, and
- You aren't entitled to collect a retirement or disability benefit based on your own earnings record that equals (or exceeds) one-half of your ex-spouse's PIA

If you are age 62 or older and you've been divorced for at least two years, you can receive Social Security benefits based on your former spouse's earnings regardless of whether that spouse is already receiving benefits. This, of course, is assuming that the other four requirements listed above have been satisfied.

## How much can you receive?

If you begin receiving benefits at your full retirement age (66 to 67, depending on your year of birth), your spousal benefit is equal to 50% of your ex-spouse's full retirement benefit (or disability benefit). For example, if your ex-spouse's benefit at full retirement age is \$1,500, then your spousal benefit is \$750. However, there are several factors that may affect how much you ultimately receive.

For example, if you're eligible for benefits based on your own earnings record then the Social Security Administration (SSA) will pay that amount first. But if you can receive a higher benefit based on your ex-spouse's record, then you'll receive a combination of benefits that equals the higher amount.

When you begin receiving benefits will also affect the amount you receive. You can receive benefits as early as age 62, but your monthly benefit will be reduced (reduction applies whether the benefit is based on your own earnings record or on your ex-spouse's.) This reduction is permanent. In other words, if you choose to receive reduced benefits at age 62, you will not be entitled to collect full benefits when you reach your full retirement age. If you decide to receive benefits later than your full retirement age, your benefit will increase by 8% for each year you wait past your full retirement age, up until age 70 (increase applies only if benefit is based on your own earnings record).

In addition, if you work after you begin receiving benefits (before you reach your full retirement age) and your earnings exceed the annual earnings limit that applies, your Social Security benefit may be reduced. Receiving a pension based on work not covered by Social Security may also result in a benefit reduction.

**Note:** *If you decide not to collect retirement benefits until full retirement age, you may be able to maximize your Social Security income by claiming your spousal benefit first. The option to file a restricted application for spousal benefits may be available to you if you were born on January 1, 1954 or earlier. By opting to receive your spousal benefit at full retirement age, you can delay claiming benefits based on your own earnings record (up until age 70) in order to earn delayed retirement credits. This can boost your benefit by as much as 32%. Because deciding when to begin receiving Social Security benefits is a complicated decision and may have tax consequences, consult a professional for help with your individual situation.*

## How does remarriage affect Social Security benefits?

If your ex-spouse gets remarried and you don't, your Social Security entitlement will be unaffected.



If you remarry, you generally can't collect benefits based on your ex-spouse's record unless your current marriage ends. Any spousal benefits you receive will instead be based on your current spouse's earnings record.

## What if your ex-spouse has died?

You may also qualify for Social Security survivors benefits based on your ex-spouse's earnings record if your former spouse has died. You may qualify if:

- Your ex-spouse was entitled to Social Security benefits
- You and your ex-spouse had been married to each other for at least 10 years before the divorce was finalized
- You are age 60 or over (or are between ages 50 and 60 and are disabled)
- You aren't currently married, and
- You aren't entitled to a retirement benefit that is equal to or greater than 100 percent of your deceased spouse's benefit

Note that if you meet the above conditions, you will be entitled to full survivors benefits; that is, you will collect an amount equal to 100 percent of your former spouse's PIA, not merely one-half. However, if you're under full retirement age, your benefits will be reduced for each month you receive benefits under your full retirement age. Benefits at age 60 will be 71.5 percent of your former spouse's PIA. It's also important to note that a divorced spouse may be entitled to a mother's or father's benefit if caring for the dependent child (under age 16 or disabled) of his or her deceased former spouse. Typically, the amount of a mother or father's benefit is equal to 75 percent of the deceased spouse's PIA. Unlike a spousal benefit, it isn't necessary for the marriage to have lasted 10 years.

For more information on how divorce may affect your Social Security benefits, contact the SSA at (800) 772-1213 or visit [socialsecurity.gov](https://www.socialsecurity.gov).



# Divorce and Risk Management

## What is risk management and how is it relevant to divorce?

Risk may be defined as the possibility of harm, injury, loss, danger, or destruction. One option to help manage risk is to purchase sufficient insurance to pay for losses. Risk management is an important topic for separated or divorcing couples. When a divorce occurs, the selection of life and health insurance beneficiaries may have to be revised and, in some cases, insurance coverage may terminate. Because it's common for one spouse to maintain health insurance for the family, for example, the breakup of a marriage can have serious consequences for the nonworking spouse. Therefore, it's important to revisit the issue of risk management when a divorce seems likely.

**Caution:** *Because divorce laws and insurance laws vary from state to state, it's important to consult experienced professionals in your state when planning for divorce.*

## How will a divorce affect your health insurance coverage?

Often, one spouse participates in a group health insurance plan at work; typically, this plan will provide coverage for both spouses. When a divorce occurs, coverage for the nonemployee spouse may eventually end (unless the divorce decree requires a spouse to continue carrying coverage on the ex-spouse).

However, temporary protection may be provided by the Consolidated Omnibus Reconciliation Act of 1986, COBRA. This federal law was designed to protect employees of larger companies (20 or more workers) and their dependents from losing group insurance coverage as a result of job loss or divorce. If your former spouse maintained family health coverage through work, you may (at your own expense) continue this group coverage for up to 36 months after the divorce or legal separation. This COBRA coverage will terminate sooner than 36 months, if you remarry or obtain coverage under another group health plan.

**Caution:** *Bear in mind that COBRA doesn't apply to a group health plan if the employer maintaining the plan normally employs fewer than 20 employees on a typical business day. Also, certain governmental plans and church-sponsored plans are exempted from the act.*

**Caution:** *Some states have enacted laws that preserve a spouse's eligibility for health insurance after separation and divorce. These laws may provide a former spouse with more generous rights than those provided under COBRA.*

- Health insurance for you--When analyzing the issue of health insurance during divorce proceedings, you should consider whether it's cheaper to continue COBRA coverage, to purchase individual coverage, or to seek coverage from your own employer (if you're employed). For young homemakers with children and older homemakers who sacrificed career opportunities for domestic concerns, COBRA coverage and purchasing individual policies may be the only choices available. Keep the cost of insurance in mind. Individual policies are often more expensive than group policies, so COBRA coverage is certainly attractive. If you decide to exercise your COBRA rights, note that your cost of continuing COBRA coverage can't exceed 102 percent of the cost to the plan for providing identical benefits to an active participant. Additionally, be aware that you have the right to pay the premiums in monthly installments.
- Health insurance for your children--When there are children born of the marriage, the child support section of the divorce agreement should address the issue of health insurance for the children--you need to assign responsibility for providing health insurance. A federal law, the Omnibus Reconciliation Act of 1993, provides some protection to those spouses who have custody of the children. This act provides for the existence of a court order that secures your children's continued health insurance coverage. This court order is called a Qualified Medical Child Support Order (QMCSO). In accordance with this order, custodial parents have the right to obtain health insurance coverage for the children through the noncustodial parent's group health plan (if any). (Note, though, that plans maintained by federal, state, or local governments, churches, and certain employers are generally not subject to QMCSO provisions.) Children who are recognized under a QMCSO can't be denied coverage by the noncustodial parent, that parent's employer, or that parent's insurance company based on any of the following reasons:
  - The child doesn't live with the noncustodial parent
  - The child isn't claimed as a dependent on the noncustodial parent's federal income tax return, or
  - The child lives outside of the plan's service area

Along with covering an employee's child under an employer-sponsored health care plan, a QMCSO can require the following:



- Deducting the premium out of the employee's paycheck
- Making insurance reimbursements directly to the nonemployee parent (if that parent pays the provider), and
- Giving the nonemployee parent information requested regarding the health care plan and reimbursements

To qualify as a QMCSO, the court order must:

- Create the child's right to receive benefits under the group plan
- Specify the employed parent's name and last known mailing address and the names of each child covered by the plan
- Specify each plan and time frame to which the order applies, and
- Not require the plan to provide any additional benefits not actually provided in the plan

## How will a divorce affect your life insurance coverage?

When you get a divorce, you need to reconsider whom to name as the beneficiary of your life insurance policies. Perhaps you might wish to name your children as sole beneficiaries. If so, be aware that if your children are under age 18 when you die, the probate court will require that a guardian be appointed to manage the insurance proceeds until your children reach age 18.

You might also consider naming your ex-spouse as beneficiary of your life insurance policy. Although this may not be your preference, it may be required as part of your divorce agreement. Because alimony terminates on the death of the payer, for example, life insurance may be used as a tool to guarantee a stream of income if the alimony-paying spouse passes away. This is equally important to ensure that child support money will continue to be available. Often the parties will stipulate in the divorce decree that life insurance will be carried on the life of the payer to replace alimony and/or child support in the event of death.

In such cases, the recipient-spouse should either own the life insurance policy or be an irrevocable beneficiary in order to ensure payment of the premiums (and to create favorable tax treatment for the payer of the premiums, if alimony is involved).

**Example(s):** Assume Liz was receiving \$300 per month in alimony from her ex-husband, Frank. The court had ordered Frank to carry life insurance on his life (payable to Liz) for as long as alimony was required. After five years, Frank stopped paying his insurance premiums and the policy lapsed. When Frank died of a heart attack the next month, alimony payments ceased and Liz learned (for the first time) that there would be no life insurance proceeds forthcoming.

**Tip:** If your divorce agreement stipulates that a new insurance policy will be purchased on the life of the working spouse (to secure alimony or child support), make sure that the working spouse applies for the policy before the divorce is final. That way, if he or she can't pass the physical exam and is uninsurable, there's still time to modify the final property settlement to make up for this problem.

## Should disability insurance be considered?

Another risk to your income is that you may become disabled or your ex-spouse (who is paying your support) may become disabled. During the discovery process of divorce, your attorney should uncover information about any disability plans at your spouse's place of employment.

While a former spouse can't own a disability policy on their ex-spouse, the former spouse can pay the premiums on the policy to ensure that it stays in force. Disability insurance is important and is a topic you may wish to address in your divorce agreement.

**Example(s):** Assume Ken agreed to pay his ex-wife \$2,000-per-month alimony, based on his \$7,000-per-month salary. After the divorce was finalized, Ken suffered an accident and became disabled. If he has no disability insurance and no salary, he can go back to court to get his alimony obligation modified. If Ken has disability insurance, he might receive \$5,000 per month tax-free and could probably continue paying the same amount of alimony.

## What about property insurance?

Real and personal property must be insured by the actual owner of the property. Therefore, applicable insurance policies must be modified or rewritten to reflect the proper owner as the insured. With respect to married homeowners, for example, the title is usually held by both spouses as joint tenants or as tenants by the entirety. In such cases, the death of one spouse will automatically vest the title to the other spouse. At the time of a divorce, a new deed should be drawn up to reflect the new arrangement and the homeowner's policy should be updated.

Divorce negotiations provide you with a number of choices regarding the house. For instance, the house can be sold immediately



and the proceeds divided. Or, both spouses can continue to own the house jointly (with a view toward a future sale). Alternatively, one spouse can keep the house and buy out the other's interest. Finally, one spouse can be awarded the house without trading other assets in return.

Again, it's the divorce agreement that should address the issue of the title to assets and property insurance. In cases involving an older homemaker or a younger spouse who has custody of children, it's not uncommon for a judge to award the entire house to such a party and to order that the other spouse pay the mortgage, property taxes, and subsidize the homeowner's insurance.



# Divorce and Debt

## What is debt and how is it classified for divorce purposes?

Like property, debt is classified as marital or separate. In general, both spouses are responsible for any debts incurred during the marriage. It doesn't matter which party actually spent the money. When the property is divided at the time of divorce, it's often the case that the person who gets the asset also gets the responsibility for paying any indebtedness secured by that asset. Even if your spouse agrees to take over the debt, joint obligors on a loan will remain jointly responsible. That is, the creditors can seek payment from either of you.

There are basically four types of debt:

- Secured debt
- Unsecured debt
- Tax debt
- Divorce expense debt

### ***Secured debt***

Secured debt gives the lienholder or lender a right to repossess the property in the event of your default on the loan. Some examples of secured debt include mortgages on your real estate, car loans, and boat loans. If a loan stands in the joint names of you and your spouse, you'll need to make it very clear in your separation agreement who will be responsible for making payments on the loan. Otherwise, if one spouse fails to make timely payments, the creditor can pursue the other spouse or (eventually) seek repossession.

### ***Unsecured debt***

Unsecured debt does not give the lender the right to repossess any specific property, although there are other remedies at law. Typical examples of unsecured debt include credit cards, personal bank loans or lines of credit, and loans from family and friends.

### ***Tax debt***

If you sign a joint return with your spouse, you're each liable for the tax debt. For three years after the due date for filing your return, the IRS can perform a random audit of your joint tax return (although the period may be longer than three years in cases of fraud or failure to file). To avoid potential tax problems in the future, your divorce agreement should spell out what happens if any additional interest, penalties, or taxes are imposed for any prior tax year. Notwithstanding any such agreement, you should be aware of the so-called innocent spouse rules, which provide certain protections to a taxpayer whose spouse understated the tax due on a joint return. A number of rules and conditions apply.

### ***Divorce expense debt***

Divorce can be expensive, and sometimes a spouse will seek a court order to make the other party subsidize attorney's fees for both sides. This might happen, for instance, when only one spouse works. Since the homemaker-spouse may have no income to pay for a divorce attorney, a judge might order the working spouse to pay.

Sometimes both parties work or have sufficient funds with which to retain attorneys. In these cases, you'll need to spell out who pays for what. For instance, if both parties want the family business, the family home, or a pension to be appraised, you'll have to apportion the costs. The same holds true if you both decide to transfer title to an asset after a divorce.

Debts can also be incurred during the separation period. If luxuries are purchased during this period, courts are likely to assign the debt solely to the party who ran up the debt. In general, debts incurred after the separation date and before the divorce is final are the responsibility of the spouse who incurred them. One exception is family necessities (i.e., food, clothing, shelter, and medical care). These necessities can be paid by the other spouse if the incurring-spouse can't afford to pay.

## What are the rules regarding joint credit card debt?





Either signer on a joint credit card can be held responsible for 100 percent of the debt, not just one-half of the debt.

**Example(s):** *Hal and Jane are seeking a divorce. During their marriage, Hal handled the finances and Jane stayed home with the children. During the discovery period of their divorce, Jane learned that Hal ran up over \$30,000 on their joint credit cards to pay for his expensive suits, dinners for friends, recreational pursuits, and the like. Since they live in a community property state, all assets and debts will be divided down the middle. Thus, Jane will be responsible for paying \$15,000 of the debt (from a judge's perspective). However, if Hal fails to keep up with his monthly payments (or, if he decides not to pay any of his \$15,000), the credit card companies can go after Jane for the full \$30,000 because the divorce settlement is not binding on creditors.*

During divorce proceedings, several issues can arise regarding credit cards, such as removing a spouse as an authorized signer, and understanding the obligations of joint credit card owners versus single card owners with two authorized signers.

## Will my former spouse's bankruptcy affect me?

Maybe. It will depend on the type of bankruptcy your former spouse chooses to file under (Chapter 7 or 13) and the type of debt owed. Debts such as alimony and/or child support payments (e.g., domestic support obligations) that are incurred as a result of a divorce decree/separation agreement, are protected from bankruptcy discharge (although a debtor's bankruptcy can be the basis for the future reduction of these types of debts). On the other hand, debts owed as a result of a property settlement may be dischargeable under Chapter 13 bankruptcy.

It is important to note that the ways in which bankruptcy and divorce affect one another are complex. As a result, you may want to consult a bankruptcy or divorce attorney for more information.

## How do you divide debt at divorce?

Basically, you have five options in allocating your marital debts:

- You and your spouse can sell joint property to raise the cash to pay off your marital debts.
- You can agree to pay most of the debts. In return, you can request a greater share of the marital property or a corresponding increase in alimony.
- Your spouse can agree to pay the bulk of the debts. In exchange, your spouse may get a greater share of the marital property or increase in alimony.
- You and your spouse divide the property and debt equally; that is, each of you gets one-half of the property and each of you agrees to pay one-half of the debt.
- If you're a homemaker with children, your spouse might be ordered to pay the bulk of the debt, pay alimony, and perhaps allow you to keep the house and a portion of other significant assets, such as your spouse's pension.

Because of the threat of bankruptcy and/or damage to your credit report, it might be wise to sell joint assets to pay off debt, or to assume responsibility for the debts yourself.

## How can I repair my credit after a divorce?

Credit problems generally stay on your record for seven years, while bankruptcies can remain for up to 10. There are some steps you can take to repair credit damaged during a divorce:

1. Obtain a copy of your credit report and look for errors. Sometimes, your credit history may be confused with someone else who has a similar name.
2. Meet with a consumer credit counseling representative. A representative can provide you with tools to negotiate with your creditors. He or she can also give you some useful suggestions for paying your bills.
3. Open a secured credit arrangement with your bank. If you deposit a specific sum of cash with a bank (such as \$500), the bank will sometimes provide you with a secured credit card. Making timely payments will help to repair your credit over time.

## What questions (relative to debt) should you consider before entering into a divorce settlement agreement?

Before sitting down with an attorney, think about which debts were contracted prior to marriage (separate debt) and which debts were contracted during the marriage (marital debt). With respect to marital debt, consider the following questions:



- If I wish to keep a particular marital asset, will I have sufficient income to keep up with the loan payments?
- Should I liquidate other assets to retire the debt completely (or partially)?
- If my spouse proposes a property settlement agreement, is there any likelihood that he or she would subsequently declare bankruptcy?
- Can I collateralize property settlement notes from my spouse so that bankruptcy will not eliminate his or her obligation to me?
- If, pursuant to our divorce agreement, my ex-spouse assumed responsibility for all credit card debt, what are my legal remedies if he defaults? How can the divorce agreement be enforced?



# New and Continuing Needs for Life Insurance in Divorce

## What is it?

You and your spouse have recently divorced or are planning to divorce. Either one of you may have life insurance policies in effect, and you probably have questions about your new and continuing needs for life insurance. You may be wondering if you still need to have life insurance coverage at all. More likely, you're wondering whether you will need additional insurance to protect your alimony or child support payments.

While married, you purchased life insurance as protection in case of the untimely death of yourself or your spouse. After a divorce, life insurance is still valuable protection for yourself and your family. Many of the concerns you shared while married will still apply after divorce. Almost as certainly, divorce will also create new concerns for you and your family.

## Protecting your children

### *Insure the life of noncustodial parent*

Much of the reason you purchased life insurance in the first place may have been to protect your children. The death of the parent responsible for child support payments could have a devastating impact on your children's financial future. The lost income could mean financial hardships for children who are dependent on the support for their basic needs and educational expenses. You will likely want to ensure that there is a sufficient amount of insurance on the life of the support-paying spouse to protect the children's financial future.

### *Change the beneficiary designation*

Divorce may also create beneficiary designation issues. Your former spouse is often the beneficiary of your life insurance policy. Many people overlook the need to change the designation after a divorce--in fact, it should be one of the first things you do. Designating your child as the beneficiary is one option; designating your estate is another.

**Caution:** *Designating the estate isn't as beneficial, however, because it could greatly increase the value of your estate and, thus, increase the potential estate tax exposure at the time of your death. As long as you live for three years after the designation, making your child beneficiary of an irrevocable life insurance trust can avoid these estate tax consequences.*

## Protecting your alimony/child-support payments

### *In general*

If you are receiving alimony or child support payments, you should protect those payments by insuring the life of your former spouse. Support payments can be critical to your own well-being, as well as to your children's. There are some options.

### *Be named the beneficiary of your former spouse's policy*

As part of the divorce settlement, the easiest option is to be named the beneficiary of any existing policies on your spouse's life. This will protect you in the event of your former spouse's untimely death.

**Caution:** *Be aware that you will have no real control over the policy. The problem is that if your former spouse still owns the policy, anything can happen. He or she may take loans on the policy or fail to pay the premiums. There is more than one story in the big city of an unscrupulous spouse changing the beneficiary designation or taking a loan on the policy, leaving an unsuspecting former spouse with little or no protection.*

### *Have existing life insurance policies transferred to you*

Having the policy transferred or assigned to you can be a valuable alimony-protection tool. When you own the policy, you are protected from your former spouse taking loans or making any other changes to it. Another benefit of ownership is that the insurance company notifies you if the premium is not paid on time. Such a transfer should be part of the divorce agreement to avoid gift tax consequences.



You may also be able to have the divorce agreement require your former spouse to continue paying the premiums on the policy transferred to you. Depending on the cost of the premiums, this can be a big help. If there's some controversy over who will pay the premiums, think of it this way: If you pay them, you have the peace of mind to know that they are being paid in a timely fashion. Moreover, if your former spouse pays the premiums, they will likely be considered alimony and, therefore, taxable to you. More on tax considerations later.

## **Purchase additional insurance on your former spouse**

As a slightly more difficult option, purchasing a policy on your former spouse can give you the protection you need along with much more control than if you are just the designated beneficiary. If it's too late to make any changes to the divorce or separation agreement, purchasing a separate insurance policy on the life of the former spouse may be your only option for protecting your alimony payments.

**Caution:** *Buying life insurance can be an expensive proposition, especially if your former spouse is older or in poor health.*

**Caution:** *An unwilling ex-spouse may not go along with extensive physical examinations or underwriting that may be required to purchase a new policy. It's a good idea to make sure that the former spouse is willing to be insured before relying on this option.*

## **Seek to have the alimony/child-support payments increased to cover the cost of additional insurance**

It may be the most beneficial option for both of you to increase the alimony or child-support payments by the amount necessary to pay for a new policy. You and your spouse can agree to this as part of the divorce settlement. This option gives you total control over the policy while at the same time protecting your alimony/child support payments.

**Caution:** *Remember that the alimony payments you receive are considered taxable income to you and are deductible by your former spouse. Notice the tax consequences in the following example.*

**Example(s):** *As part of their divorce agreement, John's former spouse, Mary, is required to pay \$500 per month in child support to John for their daughter, Abby (whom John has custody of) until she reaches age 18. Abby is 8 years old. The parties agree in the divorce settlement that the \$500 includes the cost of a 10-year term life insurance policy on Mary's life. Results: (1) The child support payments are protected until Abby reaches age 18, when they are to end normally, (2) Mary is happy because term life insurance is inexpensive, and (3) John is happy that the additional child support payments are not taxable to him as income.*

## **Protecting yourself as the noncustodial parent**

### **Insure the life of the custodial parent**

Insuring the life of the custodial parent can protect you and the well-being of your children. If the custodial parent dies, you're the one who will have to take custody of the children. Financially, this could be a very difficult situation. All of the costs of raising the children will now fall on you as the only parent. From basic needs to higher education, these costs can be extensive. A policy on your former spouse's life can prove invaluable in meeting these costs.

## **Options if you have remarried**

### **Qualified terminable interest property (QTIP) trust**

If you have remarried, a QTIP trust can be a great method for supporting your new spouse, protecting children of a prior marriage, and deferring estate taxes. Upon your death, a QTIP trust holds assets for the benefit of your current spouse for his or her life and then pays the remaining funds to a third person (typically your children) designated by you. Since the transfer is between spouses, gift taxes are avoided because the amounts used to fund the QTIP trust fall within the unlimited marital deduction. The QTIP trust also defers possible estate tax on the trust amount until the death of the surviving spouse.

**Caution:** *The potential downside of the QTIP trust is that the children (or whomever you designate) will not be able to make use of the assets until the death of your spouse.*

## **What are the tax considerations?**



## **The gift tax applies to transfers and purchases of insurance policies**

As part of the divorce settlement, you may decide to transfer your existing life insurance policy or purchase a new policy for your spouse or children.

**Caution:** *Transfer of an existing cash value policy to your ex-spouse or your children may entail a substantial federal gift tax .*

**Tip:** *If the policy is transferred to your former spouse prior to--or as part of--the divorce, gift taxes are avoided because the transfer is between spouses. A little pre-divorce planning can go a long way.*

## **Can the payment of insurance premiums be considered alimony?**

The payment of insurance premiums can be considered alimony under certain circumstances. Payments that are considered alimony are deductible by the payor (the person making the payments) and includable as taxable income to the payee (the person receiving the payments). So, if the premium payments are considered alimony, the payor spouse gets a tax benefit.

Generally, premiums paid by the payor spouse for life insurance on the payor's life made under the terms of the divorce or separation instrument will qualify as alimony to the extent that the payee spouse is the owner of the policy. For the payment of premiums to be considered alimony, the beneficiary spouse must be made the owner and the irrevocable beneficiary of the policy. There cannot be any contingencies. For example, an agreement to pay insurance premiums until the payee spouse remarries or dies is a contingent one and, therefore, not tax-deductible as alimony.

**Tip:** *If you can plan it ahead of time, it is better for the payor to agree to increase the amount of cash alimony paid by the amount necessary for the payee spouse to secure insurance on the payor's life and pay the premiums. This will be deductible as alimony by the payor and can be limited to contingent circumstances, such as remarriage or death. This solution serves both spouses' interests by creating a tax deduction for the payor and giving the payee complete control over the insurance policy.*

**Example(s):** *Spouse A agrees to an alimony payment of \$500 per month until Spouse B dies or remarries. Spouse B agrees to purchase insurance on the life of A with the money paid in alimony. Consequences: Spouse A receives a \$6,000 (\$500 X 12) income-tax deduction for alimony payments. Spouse B gets \$6,000 additional income for income-tax purposes but also gets a substitute for the lost alimony if Spouse A dies.*



# Alimony: Tax Planning

## What is alimony?

Generally, alimony is a support payment made to a former (or separated) spouse under a divorce decree (or separation instrument) in an attempt to maintain the predivorce lifestyle. Alimony is determined by state law and is sometimes called maintenance. It is based on one party's need and the other party's ability to pay. If you're contemplating a separation or divorce, you should understand the tax treatment of alimony.

## What is the basis for receiving alimony?

Deciding whether a spouse should receive alimony (and, if so, how much) is based on certain criteria that can vary from state to state. Alimony essentially allows one spouse with limited means to benefit from the earning power (acquired during the marriage) of the other spouse. In a long-term marriage, for example, often the wife has not worked outside the home or perhaps has spent many years at home caring for the children. As a couple, she and her husband may have decided that she would be responsible for caring for the children and/or running the household. These responsibilities limit her ability to build a career and can leave her in dire straits if the marriage ends.

Alimony is awarded based on any of the following criteria:

- **Need**--One of the most important reasons for alimony is that the recipient-spouse needs enough money to take care of basic needs, such as food, shelter, clothing, and utilities. Obviously, the state has an interest in keeping residents off of public assistance, and although child support is a separate issue, courts will certainly consider the existence of minor children when considering a spouse's financial need for alimony. In considering the appropriateness of alimony, courts will evaluate a prospective recipient's current sources of income, such as wages or salary, earnings from property received in the property division, and earnings from separate property (such as a trust fund).
- **Ability to pay**--The next consideration is whether the payor spouse can afford to pay what is needed and still have enough money left over to live on or to support a lifestyle somewhat similar to his or her previous one. The needs of both spouses are important.
- **Prior lifestyle**--Because courts will also consider how the spouses were accustomed to living during their marriage, it's clear that alimony isn't based simply on need. For example, if John is a Hollywood star earning \$3 million per year, he'll have a hard time convincing a judge that his former spouse, Mary, should only be paid \$35,000 per year in alimony.
- **Length of marriage**--A marriage that lasts for only a year or two may not qualify for alimony, but a 30-year marriage probably will. This is because a longer marriage will illustrate more sacrifice and dependency of the spouses and will likely involve the sacrifice of one career for management of the home and/or child rearing.
- **Age and health**--Courts will also look at the respective ages and health of the spouses when determining alimony. A judge will want to know whether either party is disabled or retired. If retired, what sources of income exist? If both parties are young, able-bodied, and college-educated, alimony might not be awarded. However, if one spouse is a 58-year-old homemaker with health problems, it might be difficult (if not impossible) for him or her to find adequate employment. In such a case, an award of permanent alimony might be appropriate.
- **Contribution to education**--The courts will also consider whether a spouse contributed to the education, training, or career advancement of the other spouse. Often, one spouse will work while the other pursues a college or graduate degree. When the degreed spouse obtains a well-paying position, the working spouse might stay home to care for the children or may continue to work in a low-paying job.

## What types of alimony exist?

Alimony may be classified as rehabilitative, permanent, modifiable, or nonmodifiable.

- **Rehabilitative**--Rehabilitative alimony may be defined as a temporary financial award to help a spouse until such time as he or she can become self-sufficient. If one party was the primary breadwinner for the couple, it's unrealistic to expect that the other spouse could automatically earn the same amount of money after the divorce. Rehabilitative alimony can help a former spouse get a college degree or take courses to update old skills. Ideally, the payments would continue while the spouse gained some working experience. Note that some states do not allow for rehabilitative alimony.



- **Permanent**--As was mentioned earlier, permanent alimony may be appropriate when the spouses are older and one party has sacrificed career for family. That party simply doesn't have the ability to get hired late in life (with no experience) in a lucrative position. Permanent alimony may also be appropriate when the recipient spouse is disabled or has health problems.
- **Modifiable**--Modifiable alimony simply means that the alimony award can be changed (i.e., increased, decreased, or terminated). A change of circumstances can warrant a change in alimony. For example, the payor spouse may become unemployed, or the recipient-spouse may suddenly become disabled or ill and unable to seek employment. Additionally, the recipient-spouse might win the lottery or receive an inheritance. After the divorce is finalized and an order of support has been made, a modifiable arrangement will allow either spouse to go back into court to ask for a modification.
- **Nonmodifiable**--Nonmodifiable alimony is not often used, since it is difficult to predict the future. Still, its value is that it provides some security or peace of mind for the recipient. If the divorce decree states that the wife is entitled to ten years of nonmodifiable alimony, for instance, she knows she can count on that money and will continue to receive it, even if she gets remarried.

## ***Do relocation and/or remarriage affect alimony?***

Relocation of one or both of the spouses doesn't affect alimony. If you obtained a judgment in one state and have since moved to another state, state laws allow you to file the judgment in the second state and enforce it there. However, if the recipient-spouse gets a roommate or shares rent with someone else, the payor spouse might be able to get a reduction in monthly alimony payments. The presumption is that you need less financial support, since your rent has been lowered.

Unlike relocation, remarriage most certainly affects alimony. In fact, remarriage of the recipient-spouse will usually cause a termination of the payor's alimony obligation (unless alimony is nonmodifiable). The written agreement between the parties will specify the conditions that will terminate the alimony.

## ***When can alimony be terminated?***

Alimony will cease upon the death of the payor or recipient. Alimony can also be terminated on the conditions agreed upon by the parties.

## ***Is it possible to guarantee alimony payments?***

Because alimony terminates on the death of the payor, it's advisable for the recipient to take measures to ensure a continued income stream in the event of the payor's death. This can be accomplished by using such tools as life insurance, disability insurance, and annuities.

- **Life insurance**--You can stipulate in the divorce decree that life insurance will be carried on the life of the payor to replace alimony in the event of his or her death. If you're going to purchase a new policy, be sure you do it before the divorce is final. This is because health and insurability aren't predictable.

The recipient-spouse should either own the life insurance policy or be an irrevocable beneficiary in order to ensure payment of the premiums and to create favorable tax treatment for the payor of the premiums. Regarding the tax aspect, the insurance premiums will be construed as alimony (i.e., they'll be tax-deductible to the payor and income to the recipient) if the beneficiary-spouse owns the policy (or is an irrevocable beneficiary) and the premiums are made under a legal obligation imposed by the divorce decree.

- **Disability insurance**--While a former spouse can't own a disability policy on his or her ex-husband or ex-wife, the former spouse can pay the premiums on the policy to ensure that it stays in force. Disability insurance can be an important consideration.

**Example(s):** Assume John agreed to pay his ex-wife, Mary, \$2,000-per-month alimony, based on his \$7,000-per-month salary. John suffers an accident and becomes disabled. If he has no disability insurance and no salary, he can go back to court to get his alimony obligation modified. However, if he had appropriate disability insurance, it's possible that he might receive \$5,000 per month tax free and could continue paying alimony.

- **Annuities**--The payor spouse can also choose to buy an annuity that pays a monthly sum equal to the alimony payment. For example, the payor spouse can buy a \$200,000 annuity that pays out \$700 per month (the agreed-upon alimony amount) in interest only. If the payments are interest only, they are taxable to the payor spouse as income and are also deductible as alimony. The payments will be treated as income to the recipient spouse.

## ***How is unpaid alimony collected?***



Unfortunately, an award of alimony doesn't guarantee the actual receipt of alimony. There are a number of methods for enforcing alimony orders, including contempt of court proceedings, garnishment of wages, and the placement of liens on property.

- **Contempt of court**--If a judge orders a spouse to pay a particular amount of periodic alimony and that order is ignored, the recipient spouse can file an action, asking that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The payor spouse can be jailed, or the judge may order him or her to make future payments in a timely manner and to pay the arrearage according to a set schedule. The judge can also order that the payor spouse's wages be garnished or can place a lien on his or her property. The judge may also order the payor spouse to pay the legal fees of the recipient spouse.
- **Wage garnishment**--With this method, a portion of the payor spouse's wages is removed from his or her paycheck at the source and delivered to the recipient spouse (or to the court). To garnish wages, the recipient-spouse obtains authorization from the court to seize a percentage of wages. Typically, a sheriff notifies the payor-spouse's employer of the garnishment. Once the employer has been instructed to garnish wages, the employee will be informed.

Of course, the payor spouse can request a court hearing to oppose the garnishment, presenting a number of objections. For example, he or she can assert that the amount owed was calculated incorrectly or that the amount to be deducted will leave him or her with an insufficient amount to live on.

- **Property liens**--In some states, a spouse who's owed alimony can ask the court to grant a lien on the real or personal property of the payor spouse. For example, a real estate attachment may prevent the property owner from refinancing or selling his or her house until the lien has been paid off. Sometimes, the recipient-spouse can even force a sale of this property to satisfy the lien.

## What are the tax ramifications of alimony?

Simply stated, alimony is taxable income to the one who receives it and tax-deductible to the one who pays it. But to be considered alimony under present tax rules, the payments must meet all of the following requirements:

- All payments must be made in cash, check, or money order (alimony payments must take the appropriate form; transfers of services or property don't qualify as alimony)
- There must exist a written court order or separation agreement

**Example(s):** John is ordered to pay Mary \$800 per month in alimony for seven years. Three years after their divorce, Mary loses her job and convinces John to increase her alimony for six months so she can find a new position. John sends her an extra \$200 per month for the next six months. At tax time, John tries to deduct this extra money as alimony. However, the IRS will disagree. Since the extra payments were not made under the terms of a divorce or separation instrument, John can't deduct the extra money as alimony.

- The couple can't opt out of alimony tax treatment by agreement after the fact--If a recipient of alimony payments doesn't wish to report the money as taxable income and the payor spouse agrees not to take a tax deduction, it doesn't matter; the payments are still taxable to the recipient and deductible by the payor. However, in the divorce decree itself, spouses may designate payments as "not alimony" even though the payments would otherwise qualify as alimony. Such payments are not taxable to the recipient or deductible by the payor.
- The divorced couple can't stay in the same household--Sometimes, a couple gets divorced but neither party can afford to move out. Consequently, they might agree to live together. If alimony is paid, the payor will not be able to deduct it on his or her federal income tax return and the recipient will not include it in income. Living in the same household prevents this tax treatment.
- The obligation to pay alimony must end at death of spouse--The obligation to make payments ceases upon the death of the payor or the recipient.
- The former spouses may not file a joint tax return--Many couples mistakenly file a joint return for the year they get divorced; this is incorrect. Filing status will be determined by their marital status on the last day of the year (December 31).
- If any portion of the payment is considered to be child support, that portion can't be treated as alimony. Sometimes an order for spousal support will not use the words "child support," but a portion of the payment can be inferred to be child support nevertheless.

Different rules may apply if your divorce was finalized before 1985. For more information about previous rules, contact an attorney.

## What are the recapture rules?





The tax deductibility of alimony may encourage the spouses to disguise property settlement payments as alimony, so, the law provides alimony recapture rules. Alimony recapture is calculated by looking only at the first three calendar years during which deductible alimony was claimed. Therefore, any alimony payments made after the third calendar year are not subject to the recapture rules.

Alimony recapture rules require deductible alimony payments during the first three years to be structured so that payments are substantially equal. However, alimony payments of less than \$15,000 per year aren't subject to the recapture rules. The goal is to prevent "front-loading" of alimony. Deductible alimony payments will be recharacterized as nondeductible property settlement payments to the extent that payments made during the first two years are excessively front-loaded. In other words, high sums of alimony are paid during the first two years.

There are four exceptions to the recapture rules. The recapture doesn't apply:

- If either spouse dies during the first three years and the payments cease by reason of that death
- If the recipient-spouse remarries during the first three years and payments cease by reason of the remarriage
- To temporary support payments made pursuant to a court order
- To payments that fluctuate for reasons not in control of the payor spouse

**Example(s):** Ray agrees to pay Dorothy 25 percent of the net income from his farm each year for three years. In the first year, his net income is \$120,000, so Dorothy gets \$30,000. In the second year, severe weather wipes out many crops, and the net income is only \$32,000, so Dorothy gets \$8,000. In the third year, the farm suffers a loss rather than net income, so Dorothy gets nothing. In this case, no recapture will be required.

For more information about the recapture rules, contact an attorney or accountant.



# Child Support: Tax Planning

## What is child support and who is responsible for paying it?

Every parent is obligated to financially support his or her children, providing such necessities as food, clothing, shelter, etc. Divorce doesn't cause this obligation to cease. When a divorce occurs, the noncustodial parent is usually ordered to pay some child support to the custodial parent; the rest of the child's expenses are paid by the custodial parent.

Child support may end at the child's 18th birthday, although some states set a cutoff at 21 years of age if the child is principally dependent on one parent (absent an agreement between the parties for a higher age). Also, some courts may order that child support continue until the child has graduated from college.

*Tip: Some courts may also order child support to continue if the child has significant special needs.*

## How do you determine the amount of child support?

The amount of child support that the noncustodial parent pays to the custodial parent can be simply a matter of agreement between the parents or it can be ordered by a judge. All states now have child support guidelines that help the court decide the amount of child support to be paid. However, there can exist considerable variation among states regarding the precise formula used to determine child support. Judges will carefully review agreements by the parents to ensure that the best interests of the child (or children) are kept in mind.

Often, the support obligation of each parent is based on the ratio of each parent's income, the percentage of time the child spends with each parent, the number of children, and the amount of alimony paid (if any). A child support worksheet is provided by the court to determine the amount. To complete a typical worksheet, each parent must determine his or her weekly (or monthly) available income (gross income minus taxes, Social Security, and other mandatory deductions). Optional deductions (like contributions to a 401(k) plan) aren't deducted.

When both parents are working, one method of determining support assigns a percentage of child-rearing costs to each parent based on his or her proportionate contribution to household income. When only one parent is employed, the amount of child support is assigned after determining the basic living expenses necessary for that parent.

**Example(s):** Assume Mary and John have two children and are seeking a divorce. Mary will have custody of the kids. Mary grosses \$900 per month and John grosses \$4,300, for a combined total of \$5,200. Thus, John earns 83 percent and Mary earns 17 percent of the total. Their particular state mandates that a household with two children should provide \$983 per month to maintain two children. Since 83 percent of \$983 is \$813, John owes Mary \$813 per month in child support.

Because there are a number of methods for determining the amount of child support to be paid, it is necessary for you to consult with the child support guidelines and worksheets provided by your own state. You should be able to obtain a worksheet at the probate court for your county.

## Can you modify a child support order?

Child support orders can be modified by a court even after a divorce has been finalized. The basis for modifying a child support order is that there has been a substantial change in circumstances for one or both parties. For example, perhaps one spouse lost his or her job after the divorce or the second spouse got a big raise or won the lottery. In general, a substantial change in circumstances may be defined as any change that significantly increases living expenses or increases (decreases) the income of a parent. Of course, a modification can also be sought if one parent fraudulently failed to disclose all of his assets and income when the child support worksheet was completed.

Your request for modification of child support will be either contested or uncontested. Courts often provide a standard form for modifying child support--you fill in all relevant information (including how circumstances have changed) and check off a box to indicate whether the matter is contested. In an uncontested case, the parents will voluntarily agree so there will be no opposition motion or pleading filed. In a contested matter, you will have to take your dispute to court. Keep in mind that once a court sets a support order, only a court can modify it. If you make an informal modification and your ex-spouse changes his or her mind, you won't have any protection regarding an arrearage.



## Who pays for the child's medical expenses, education, and other incidentals?

The provisions of your child support agreement must be specific and free of ambiguities in order to prevent disagreement at a later date. Try to anticipate future expenses. For example, dental bills can normally be expensive for children since braces are often needed. Medical insurance is also vital. In some families, a college education is expected and viewed as a necessity. Finally, paying for day care or other forms of child care when both parents work is also a significant expense and should be considered in any agreement.

If one parent is working and the other stays at home to care for the children, it's probably advisable to provide in the child support agreement that the working parent maintain health and dental insurance for the children on his employer plan. For high-net-worth families, the agreement might provide that the party with the higher income completely subsidize college education for the child (or children). On the other hand, perhaps each party will agree to pay a percentage of the college costs. Other questions you might want to consider include:

- Who will be responsible for repaying student loans
- Who will be responsible for subsidizing graduate school (if any)
- Who will pay for SAT preparation courses

Naturally, if the parents can't reach an agreement on these incidentals, it will be up to the judge to decide. Few, if any, states require payment for graduate school.

Finally, you should consider the issue of insurance--both life and disability insurance. A child support agreement will do you little good if the noncustodial parent dies or becomes severely disabled and unable to work. The settlement agreement can require the parent paying child support to purchase life and disability insurance to protect the income stream. If you suspect that the premiums won't be paid, you (the spouse receiving support) can own the policies and pay the premiums.

## How is unpaid child support collected?

Unfortunately, an award of child support doesn't guarantee the actual receipt of support. There are a number of methods for enforcing child support orders, including garnishment of wages, interception of tax refunds, commencement of contempt of court proceedings, public humiliation, the placement of liens on property, and the denial of state licenses.

### ***Wage garnishment***

The most common method of collecting a judgment for child support is a wage garnishment. Here, a portion of the noncustodial parent's wages is removed from his or her paycheck at the source and delivered to you; with unpaid child support, up to 50 percent of net wages can be taken. To garnish wages, the custodial parent obtains authorization from the court to seize a percentage of the noncustodial parent's wages. Typically, a sheriff notifies that parent and his or her employer of the garnishment. Once the employer has been told to garnish wages, the employee will be informed.

Of course, the noncustodial parent can request a court hearing to oppose the garnishment and present a number of objections. For example, he or she can assert that you incorrectly computed the amount owed or that the amount to be taken will leave him or her with an insufficient amount to live on.

### ***Intercepted tax refunds***

Federal and state income tax refunds may be intercepted by the IRS and state departments of revenue and forwarded to your district attorney's office (or other state office charged with overseeing child support enforcement). The appropriate office will see that you get the money.

Before a refund is intercepted, the debtor will receive a written intercept notice, notifying him or her of a chance to request a hearing to object to the intercept. Relevant grounds for an objection include that the amount of the back support has already been paid or that the notice requests more than what is owed.

If the payer spouse is remarried and files a joint tax return, and that spouse's refund is intercepted, his or her new spouse's share of the federal refund can generally be returned. The new spouse should file IRS Form 8379 (Injured Spouse Claim and Allocation) and attach it to the tax return.



## Contempt of court

If a judge orders a parent to pay a particular amount of periodic child support and the parent doesn't pay, the parent who's owed the child support can file an action before the court to ask that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The delinquent party can be jailed, or the judge may order him or her to make future payments in a timely manner and to pay the arrearage as well according to a set schedule. The judge can also order the delinquent spouse's wages withheld, place a lien on his or her property, or order him or her to post a bond. In addition, the judge can order the delinquent spouse to pay the opposing party's legal fees.

## Public humiliation

In recent years, states have come up with more creative ways to obtain back child support. For example, most state child-support enforcement agencies now publish a "Most Wanted" list of parents who owe substantial child support, posting photographs and amounts owed.

## Property liens

In some states, a custodial parent who is owed child support money can ask the court to grant a lien on the payer spouse's real or personal property. A real estate attachment, for example, may prevent him or her from refinancing or selling the house until the lien has been paid off. Sometimes the custodial parent can force a sale of the payer spouse's property to satisfy the lien.

## Denial of state license

In a number of states, the debtor-parent's professional license (e.g., doctor's license, attorney's license, etc.) will not be renewed by the state if substantial back child support is owed. Some states will even fail to renew driver's licenses.

## Can relocation and/or remarriage affect a child support order?

Relocation of the parties and/or remarriage don't affect child support orders. The natural parents of a child continue to be responsible for support of the child, even if the custodial parent remarries. However, if the custodial parent moves out of state with the children, a noncustodial parent's increased transportation costs to visit with his or her children may constitute a substantial change in circumstances and warrant a decrease in child support.

Regarding arrearages in child support payments, even if a judgment was obtained in one state and the payer spouse has since moved to another state, state laws allow the custodial parent to file the judgment in the second state and enforce it there.

## What are the tax ramifications of child support?

Briefly put, child support is not taxable to the one who receives it, nor is it deductible to the one who pays it.

### Is it child support?

For payments to be classified as child support, the divorce decree or separation agreement must:

- Fix a sum that is payable for the support of a child (this can be either a dollar amount or a specific fraction of a payment). For example: Husband will pay \$500 per month child support to Wife.
- Provide that the amount payable by the payer spouse to the receiving spouse will be reduced in the event of some contingency relating to a child (such as the child's marrying, dying, leaving school or reaching a designated age). For example, Husband will pay \$500 per month child support to Wife until child reaches age 18.

OR

- Provide that the amount payable by the payer spouse to the receiving spouse will be reduced at a time that can clearly be "associated with" a contingency relating to a child.

**Example(s):** *Husband agrees to pay Wife \$2,500 per month until she dies. (The words "child support" are not specifically mentioned.) Wife has custody of the couple's child, Justin, who was born on October 20, 1997. The divorce agreement states that on January 1, 2016, Husband's required payment to Wife will decrease to \$1,700 per month. Because Justin will turn 18 years old within six months of the date on which the payment is scheduled to decrease, the payment reduction is assumed to relate to Justin's reaching 18 years old. Therefore, the \$800 per month reduction is treated as child support unless the parties can rebut*



this presumption.

In this example, part of the husband's payment is characterized as alimony and part as child support.

## **Who can claim an exemption for the child as a dependent on the federal income tax return?**

The general rule is that unless otherwise specified, the dependency exemption usually goes to the parent who has physical custody of the child for the greater part of the calendar year (i.e., the custodial parent), regardless of how much support was provided by each parent.

**Example(s):** Frank and Liz separated in May. Their daughter, Carol, lived with Liz for the rest of the year, and Frank provided all the support for Liz and Carol that year. Because Carol lived with Liz longer than she lived with Frank, Liz may claim the dependency exemption, even though she made no actual financial contribution toward Carol's support.

However, there are circumstances when the noncustodial parent can claim the dependency exemption instead of the custodial parent. To do so, the noncustodial parent must meet one of the following conditions:

- The custodial parent must sign a written declaration that he or she will not claim the exemption for the child for the tax year, and the noncustodial parent must attach this declaration (IRS Form 8332) to his or her tax return (if a divorce or separation agreement went into effect after 1984 and before 2009, the noncustodial parent may be able to attach certain pages from the decree or agreement in place of IRS Form 8332), or
- A qualified pre-1985 instrument between the parents must provide that the noncustodial parent can claim the child as a dependent (the noncustodial parent must also have provided at least \$600 for the support of the child during the year).

Note: Once the minor child reaches majority age under state law, the exemption goes to the parent who actually provides more than 50 percent of the child's support.

## **Child-care credit**

A custodial parent who pays child-care expenses so that he or she can work may be eligible for a tax credit for a portion of those expenses--up to 35 percent, depending on income. The qualifying expenses on which that percentage is based are limited to \$3,000 for one qualifying dependent, or \$6,000 if there is more than one dependent.

Only the custodial parent is entitled to claim the child and the dependent care credit. This is true even if the custodial parent does not claim the dependency exemption for the child. A noncustodial parent may not claim a child-care credit for expenses incurred even if that parent is entitled to claim the exemption for the child.

**Example(s):** Assume John and Mary have a son, Benny, who lives with Mary four days a week and with John three days a week. John and Mary are both singers and work outside the home. Each parent pays half of the \$4,000 per year that it costs to keep Benny in day care during the week. Mary is entitled to claim a child-care credit for her share of the day-care expenses. She's considered the custodial parent because Benny spends a greater portion of time with her than with his father.

## **Head of household filing status**

The head of household filing status is available for those who are unmarried (or treated as unmarried for tax purposes) at the end of the calendar year, who provide more than half the cost of maintaining the household, and whose household is the principal home of at least one qualifying person for more than half of the year. (A qualifying person is their child or any other person who qualifies as their dependent.)

**Example(s):** John and Sue have an eight-year-old son, Tim. John and Sue obtained a divorce on January 1, 2016, and Sue was awarded custody of Tim. Tim lived with Sue throughout the year. When Sue files her 2016 tax return, she can claim head of household filing status.

The head of household filing status is also available to a married (separated) taxpayer under certain circumstances. The taxpayer must meet all of the following tests:

- The taxpayer's spouse did not live in the taxpayer's household at any time during the last six months of the calendar year
- The taxpayer files a separate return for the year
- The taxpayer maintains his or her home as a household that was the main home for a child stepchild, or adopted child for



more than half of the year (a foster child must be a member of the household for the entire year)

- The taxpayer is entitled to claim the child as a dependent
- The taxpayer provides more than 50 percent of the cost of maintaining the household



# Dependency Exemptions: Divorce

## What is a child dependency exemption?

If a separated or divorcing couple has children, an important tax decision involves assignment of the child dependency exemption. Exemptions are fixed amounts that you subtract from your adjusted gross income (AGI) to calculate taxable income. You can deduct \$4,050 for each exemption you claim (for 2016, \$4,000 for 2015). Along with personal exemptions, you're generally allowed one exemption for each person you can claim as a dependent. To claim a dependency exemption, you must first have a "qualifying child" or a "qualifying relative." In making this determination, special rules apply to separated or divorced parents. For purposes of this discussion, it is assumed that the child is a "qualifying child" of one or both parents and not a "qualifying relative."

For more information on the dependency exemption, including the tests to determine who is a "qualifying child" or a "qualifying relative," see IRS Publication 501 titled Exemptions, Standard Deduction, and Filing Information.

## Who can claim the child dependency exemption?

Assuming you have a child who is under age 19 at the end of the year (or a full-time student under age 24 at the end of the year, or a child who is permanently and totally disabled at any time during the year, regardless of age), the general rule for separated or divorced parents is that the custodial parent (the one with whom the child lived for the greater part of the year) is typically the one who claims the dependency exemption, regardless of how much support was provided by each parent.

**Example(s):** Frank and Liz separated in May. Their daughter, Carol, lived with Liz for the rest of the year, but Frank provided all the financial support for Liz and Carol that year. Because Carol lived with Liz longer than she lived with Frank, Liz may claim the dependency exemption, despite the fact that she made no actual financial contribution toward Carol's support.

## What are the exceptions to the general rule?

There are exceptions to the general rule that the custodial parent is the one who claims the dependency exemption. Specifically, a child will be treated as the "qualifying child" of the noncustodial parent if one of the following conditions is met:

- The custodial parent must sign a written declaration that he or she will not claim the exemption for the child for the tax year, and the noncustodial parent must attach this declaration (IRS Form 8332) to his or her tax return (if a divorce or separation agreement went into effect after 1984 and before 2009, the noncustodial parent may be able to attach certain pages from the decree or agreement in place of IRS Form 8332), or
- A qualified pre-1985 instrument between the parents must provide that the noncustodial parent can claim the child as a dependent (the noncustodial parent must also have provided at least \$600 for the support of the child during the year).

## Does the child dependency exemption affect your ability to claim the child-care credit?

A custodial parent who pays dependent child care expenses so that he or she can work may be eligible for a tax credit for a portion of those expenses--up to 35 percent, depending on income. The qualifying expenses on which that percentage is based are limited to \$3,000 for one qualifying dependent, or \$6,000 if there is more than one qualifying dependent. To claim this credit, the parent must maintain a household that is the home of at least one dependent, and the day-care expenses must be paid to someone who's not claimed as a dependent.

Only the custodial parent is entitled to claim the child and the dependent care credit. This is true even if the custodial parent doesn't claim the dependency exemption for the child. A noncustodial parent may not claim a child care credit for expenses incurred even if that parent is entitled to claim the exemption for the child.

**Example(s):** Assume John and Mary have a son, Benny, who lives with Mary four days a week and with John three days a week. John and Mary are both singers and work outside the home. Each parent pays half of the \$4,000 per year that it costs to keep Benny in day care during the week. Mary is entitled to claim a child-care credit for her share of the day-care expenses; John is not entitled to claim his portion. She is considered the custodial parent because Benny spends a greater portion of time with her than with his father.



# Property Settlements and Third-Party Transfers

## What are property settlements and third-party transfers?

When marital separation occurs and a divorce is contemplated, spouses must decide how to divide their property. Property includes such assets as the family home, rental property, automobiles, pensions, bank accounts, and stocks and bonds. It also includes art and antique collections, furniture, IRAs, life insurance cash values, and family businesses. A formal property settlement agreement is usually drawn up and signed by the couple, formally assigning assets to one spouse or the other. In some cases, the couple may decide to sell one or more assets to a third party, splitting the proceeds. This type of transaction is known as a third-party transfer.

Although it's important for divorcing spouses to understand the property laws regarding the division of marital property, it's also essential for them to understand the tax implications of their decisions.

## How is property classified for divorce purposes?

Assets are divided in accordance with state laws, and states can be divided into two categories, based on their property division rules: community property states and equitable distribution states.

### Community property states

In general, community property states focus on the difference between separate property and community property. Separate property is that which you bring to the marriage, including inheritances and gifts received prior to marriage. Community property, on the other hand, may be defined as property acquired during the marriage (except for inheritances and gifts received during the marriage). Separate property can usually be kept by the owner-spouse after a divorce, while community property must be divided equally (50/50) rather than fairly between the spouses.

**Example(s):** Assume John and Mary are married and live in California, a community property state. Prior to their marriage, Mary received a \$50,000 inheritance from her grandmother. During the course of their marriage, Mary received a \$20,000 inheritance from her aunt. John and Mary bought a \$500,000 house together during their marriage and amassed a \$50,000 savings account. If John and Mary seek a divorce, both of the inheritances are considered separate property and will go to Mary only. However, the house and savings account are considered marital property and must be divided equally (50/50) between John and Mary. That is, each spouse will get \$25,000 from the savings account and \$250,000 in cash (or assets), assuming that the house is worth \$500,000 on the date the spouses select for valuation.

At present, the following are community property states: Alaska (which has an optional system), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (and also Puerto Rico).

### Equitable distribution states

The majority of states follow an equitable distribution philosophy. These states agree that marital property should be divided equitably (fairly) rather than equally. Some of these states will include separate property (such as inheritances and gifts) in equitable distribution, and some will not.

Equitable distribution states fall into three categories, based on how they identify marital property.

- Type 1--The first type of state identifies marital property as all property except that which either spouse brought into the marriage or obtained by gift or inheritance at any time. This definition is identical to that espoused by the community property states. The difference is that marital property will be divided equitably, as opposed to equally.
- Type 2--The second type of equitable distribution state proclaims that regardless of how or when property was acquired, all property (of both spouses) is subject to division at divorce. These states don't differentiate between marital and separate property. They divide property fairly and equitably and may allow property brought into the marriage by gift or inheritance to go to the other spouse if this form of distribution seems more fair, all things being considered. However, the source of the property (i.e., gift, inheritance, owned prior to marriage) is often very important in the judge's decision-making process.

**Example(s):** Assume John owned a \$10,000 savings account and a \$100,000 house. When he got married to Mary in a Type 2 equitable distribution state, he kept the title to these assets in his name alone. During the course of their marriage, the couple





bought a vacation condominium in Florida and two automobiles and amassed \$100,000 in mutual funds. If John and Mary seek a divorce, all of the property (including John's house and personal savings account) will be subject to equitable distribution principles.

- Type 3--The third category of equitable distribution state favors a mix of rules. Such states use fairness as a means of division but don't exempt all gifts, inheritances, and property brought into marriage from division. Instead, they may exempt one or more of these types of property.

**Tip:** To determine which category your state falls into, check the domestic relations laws of your state or consult with an attorney.

## How is property valued?

Once property has been classified as marital or separate, the next step in the process is to establish values for all of the identified property. Valuation may be by mutual agreement of the spouses. Certainly it's a simple matter to ascertain the fair market value of bank accounts, stocks, and bonds. And the fair value of household goods is usually determined by mutual agreement. However, in complicated cases involving pensions, family businesses, real estate, stock options, and so on, both sides may need to hire experts to establish values. This may be particularly true if your state recognizes professional licenses, advanced degrees, and enhanced earning power as marital property.

**Example(s):** Assume two premed students, Mary and John, got married. The couple agreed that John would complete his education first, while Mary supported him. When he finished, she would then complete her education. After John's second year of residency, he decided to divorce Mary. The court decided that because John's medical school degree and license to practice were both obtained during the marriage, they should be considered marital property, subject to valuation and division. An expert provided the court with present-value calculations of John's future earnings and came up with the figure \$500,000.

**Tip:** In second marriages, sometimes a house is brought into the marriage. When such a house appreciates in value during the course of the second marriage, valuation can be a problem. Keep in mind that although separate property may not be subject to division in some states, the appreciation in value of separate property during the course of the marriage may be subject to division, particularly if both spouses used the property and contributed to the increased value.

**Example(s):** Assume Mary owned a \$100,000 house with a \$60,000 mortgage when she entered into a second marriage with John. Mary kept the title to the house in her name but lived there for many years with John. Mary now wishes to divorce John. The house is presently worth \$160,000, and the mortgage has been brought down to \$40,000. How should the property be valued?

**Example(s):** Mary may assert that the only marital asset is the increase in property value--\$60,000. She obtained this figure by subtracting \$100,000 from \$160,000. John could argue that the increase in equity (not the increase in property value) is the marital asset. This figure would amount to \$80,000 (\$120,000 equity minus \$40,000 equity). In most states, there is no definitive answer--the parties will have to agree or a court will have to decide.

**Caution:** The concept of gifting must also be considered when discussing valuation. In this example, if Mary had added John's name to the deed during their marriage, nearly all courts would hold that Mary converted the separate property into marital property. Thus, the entire house would be subject to division rather than the mere increase in appreciation.

The date of valuation is a matter usually determined by the parties themselves. For example, a couple might agree to value assets as of the separation date or at another mutually acceptable time. In some states the date of valuation is the date of the divorce trial.

## How do you approach property division?

The division of property will eventually be reduced to a written agreement--the Property Settlement Agreement. A property settlement agreement, once it has been signed by the parties, is a binding agreement and becomes part of the divorce decree. In cases where alimony or child support is needed immediately, a temporary order is often sought first.

When considering the division of property, both spouses must gather information about their assets. If you hire a divorce attorney, he or she will want to see financial statements from each spouse. It is necessary to know the amount, the frequency, and the source of periodic income. Likewise, parties must disclose the sources, locations, and fair market values of their assets. Of course, debt must also be disclosed.

There are occasions when one spouse has been kept in the dark about financial matters or perhaps chose not to take an active role. For example, one spouse may have handled the bills, bank accounts, and securities, while the other cared for the children



and ran other domestic affairs. In legal terminology, the discovery process will help the less financially savvy spouse gather the necessary information.

During discovery, a spouse can request copies of income tax returns, any insurance policies that may exist, credit reports, employee benefit statements and summaries, bank account summaries, and other documents. Written questions (called "interrogatories") about income, assets, debts, and documentation may be served on (and answered by) the other spouse. Also, depositions of each spouse may be taken.

## What about hidden assets?

Sometimes, when a marriage has been deteriorating for many years, one spouse will hide the existence of assets from the other spouse in the expectation that a divorce may occur someday. If you find hidden assets, you will probably want to reveal them prior to trial in order to obtain your spouse's consent to a more equitable settlement. However, you can also choose to wait until the trial, undermining the credibility of your spouse.

**Example(s):** *John handled the finances in his family and secretly stashed away \$50,000 in a bank account during the last years of his marriage. When divorce proceedings began, he wire-transferred the money to his mother, a resident of Columbia. John's wife, Mary, learned of the money when she found a receipt for the wire transfer in her husband's coat pocket. Since John had not disclosed the existence of this money at discovery or in his financial affidavit (submitted to the court), Mary was able to use this fraudulent transfer as leverage to force a favorable property settlement.*

There are a number of places where you can look for hidden assets:

- Personal income tax returns--A review of the personal returns filed for the past five years may indicate sources of interest or dividends. They may also reveal unknown sources of income or loss from trusts, partnerships, or real estate holdings. You should review federal, state, and amended returns, comparing them to 1099s and W2s.
- Partnership tax returns--Compare partnership returns (IRS Form 1065 and Schedule K-1) over a number of years to see whether any sudden changes in the partnership interest or distribution occurred around the time of a marital separation. (Sometimes, compensating adjustments are made after the divorce has been finalized.)
- Corporate tax returns--If one spouse is the principal owner of a closely held business, he or she may be manipulating salary by taking loans from the corporation or may be charging personal expenses to corporate accounts. Corporate returns should also be checked for excessive retained earnings, as this may disguise available profits or an artificially low salary level.
- Financial statements--If your spouse took out a loan for his or her business or for personal purposes, he or she submitted a financial statement to the lending institution. Look back at these statements for a five-year period to find assets that may no longer be accounted for.
- Savings account passbooks--You should acquire the passbooks for any savings accounts opened in the last five years, looking for substantial withdrawals close to the time of separation. Also, periodic withdrawals (or deposits) could indicate mortgages (or income) from hidden sources.
- Canceled checks and check registers--You may come across canceled checks for the purchase of property that you never knew existed. Compare the canceled checks against the applicable bank statement to make sure that you were given all of the canceled checks (some may have been removed by your spouse).
- Securities statements--Brokers furnish periodic statements, indicating transactions involving stocks and bonds. A review of these statements may raise a question about sales proceeds--where did the money go? You can cross-check securities transactions with bank account information by date and amount to see what may have happened.
- Uncollected bonuses and commissions--By subpoena, check with your spouse's employer to learn if any bonus or commissions are being held back.
- Children's bank accounts--Sometimes, a spouse who wishes to hide money will open a custodial account in the name of his or her child. If the annual interest from this account is less than the standard deduction amount for a dependent for that tax year, it's not shown on income-tax returns, nor are returns filed for the children.
- Phony loans, debts, or employees--To keep cash from being divided, a spouse may suddenly announce that he or she needed to repay a relative or friend for a loan made many years ago. These loans are suspect if made proximate to the marital separation. Also, if one spouse controls the payroll of a sole proprietorship, partnership, or closely held business, he or she may have a relative or friend on the payroll who's not really providing adequate services for the business. Thus, the business's profits will be reduced, and your spouse may be drawing a lower salary and getting a kickback.

## In what ways may property settlements be structured?



Property settlements may be structured in a number of different ways.

## Equal divisions

You begin by listing all of the marital assets (and their corresponding values). In a 50/50 split, of course, each party would be given one-half of the cash value of the assets. But perhaps one spouse might want to keep the entire house and one-half of the savings account, while the other spouse might want to keep the entire pension, one-half of the savings account, and the sole proprietorship. An example will illustrate that one spouse might end up owing the other spouse money if a 50/50 split is necessitated.

**Example(s):** Assume John and Mary have been married for 20 years and are now seeking a divorce. They own a house (worth \$150,000), a pension (valued at \$80,000), a savings account (worth \$30,000), and a sole proprietorship (Acme Industries, estimated at \$100,000). They don't want to sell assets and split proceeds; rather, Mary and John have tentatively decided to divide their assets as follows:

Asset	Mary	John
House	\$150,000	
Pension		\$80,000
Savings Acct.	\$15,000	\$15,000
Acme Ind.		\$100,000
Total	\$165,000	\$195,000

**Example(s):** If a 50/50 property split is contemplated, John will owe \$15,000 to Mary. In this example, the appropriate division can be accomplished with a property settlement note. John can make monthly payments to Mary (with interest) until the \$15,000 has been paid in full.

## Property settlement note

A property settlement note is a promise from the payer to the payee to pay a particular sum, for a particular length of time, with reasonable interest. The note should be collateralized. For tax purposes, the note doesn't represent alimony; it's purely a property settlement. Therefore, the payer can't deduct these payments from income. Likewise, the recipient doesn't include the principal payments in income (but he or she does include the interest portion in income).

**Caution:** Also, keep in mind that a property settlement note can be discharged in bankruptcy, whereas alimony and child support payments cannot.

## Equitable divisions

A 50/50 split may not produce equal results--or equal standards of living after the divorce--if the two spouses are unequally situated after the divorce. For example, an older homemaker who sacrificed her career for the care of her children and the upkeep of her home may not be able to maintain a standard of living equal to her former spouse after a divorce, even with a 50/50 split. Later in life, her husband may command a top salary, while she has no work history and few marketable skills. After a divorce, he will continue to reap a high income, while she will need to receive alimony or be required to drain assets.

Another example involves separate property. If the homemaker wife, for example, has \$4 million worth of separate property sitting in a trust fund, a judge may find that a 50-50 split of the marital assets would be inequitable to the husband. States that use equitable principles in dividing property may consider a number of factors, including the following:

- Contribution by the spouses--Courts will consider financial contribution to assets and also non-economic contributions, such as homemaker services (child-rearing, housecleaning, career-sacrifice, etc.). Some states will assume that the contributions of a homemaker are equivalent to the contributions of the full-time wage earner, while others will admit expert testimony to place a value on homemaker services.
- Courts will also look at contribution by one spouse to the education of the other spouse. As cited in an earlier example, one spouse might work to put another through medical school. The increased earning power of the doctor-spouse might be viewed as "property" in some states.



- Duration of marriage--In a short-term marriage, direct financial contribution to assets plays a larger role, whereas in a long-term marriage, greater weight is given to noneconomic contributions, such as homemaker services.
- Future financial needs--Some states will consider the future financial needs of the spouses and/or the children when dividing property. While this is seldom a factor in marriages of very short duration, it can be a factor in long-term marriages.
- Income--If the income of one spouse differs substantially from that of the other spouse, this may influence the judge's division of property. For example, the judge may award a higher percentage of the property to the more dependent spouse, or alimony payments may be ordered.
- Assets and separate property.
- Extent of debts and ability to pay.
- Age and health of the spouses.
- Employability and future earning capacity.
- Educational degrees and professional licenses--When a spouse's education, degree, or training received during marriage substantially enhances that spouse's earning capacity, a court may order that spouse to compensate the other spouse for financial support and reduced discretionary income during the educational process. For example, the court may:
  1. Reimburse money spent on tuition, student loans, books, supplies, and other educational costs
  2. Allocate balances remaining on student loans solely to the educated spouse for repayment
  3. Use alimony to compensate the nonstudent spouse for financial and emotional support

**Tip:** Alternatively, of course, the court may determine that the degree or license is marital property, subject to division. As was mentioned earlier, a present value of future earnings might be divided between the spouses in such a case.

- Tax consequences.
- Financial and emotional needs of the children--Note that a marital home may be given to the custodial parent if minor children are involved.
- Standard of living during the marriage.
- Fault (in some states).
- Conduct during the marriage (in some states).

## What are the tax implications of property dispositions?

Property transfers between spouses during the marriage or incident to divorce aren't taxable. However, the tax effects of property dispositions can vary greatly, depending on whether you decide to transfer property immediately to your spouse, sell it to a third party, or sell it to your spouse at some future time.

### ***Transfer to spouse incident to divorce***

Neither spouse recognizes gain or loss if you transfer the title of the property to your spouse incident to a divorce. A transfer of property is viewed as incident to divorce if the transfer occurs within one year after the date on which the marriage ends or if the transfer is related to the ending of the marriage. Any transfer of property between spouses that is made pursuant to a divorce or separation instrument and that occurs within six years after the date the marriage ceases is presumed to be related to the cessation of the marriage.

### ***Basis***

The spouse receiving the property takes the basis of the transferring spouse. This result occurs even if the spouse that retains the property pays cash or other assets in return for the property and the transaction is basically a sale.

**Example(s):** Assume Mary sells her half-ownership interest of their home to her spouse, John, for \$85,000 as part of their divorce settlement. Because the property had initially been purchased for \$80,000, Mary's basis was \$40,000 and John's was \$40,000. Mary doesn't recognize any gain on the sale to John because the sale was incident to their divorce. John's basis in the property will be \$80,000.

### ***Sale of property to third party immediately***

Often, a piece of property will be sold to a third party as part of a divorce settlement, and the proceeds will be split between the spouses. In such a case, each spouse will recognize one-half of the gain on the sale (unless they qualify for a capital gains



exclusion ).

## **Delayed sale**

The parties might decide that the property will be sold to the other spouse at some point in the future. If sold later than six years from the marriage cessation date, the sale will generally not be considered incident to the divorce. Thus, the seller will recognize capital gains and losses. This is not to be confused with the promissory note arrangement mentioned earlier.

**Tip:** *While a sale made more than six years after the marriage cessation date is presumed not to be incident to the divorce, the presumption will not apply if it can be demonstrated that the transfer was made to carry out the division of property owned at the time the marriage ended. For example, a sale might be considered made incident to a divorce if business or legal factors prevented an earlier transfer of the property and the transfer was made promptly after those factors were taken care of.*

## **Is the family home given special treatment?**

With respect to ownership and division of the family home, special rules apply both in community property states and in equitable division states. In a community property state, the family home can be considered marital property even if one spouse separately brought it to the marriage. This is true if both spouses lived in the home during the marriage and also if the nonowner spouse contributed to the house's appreciation in value over the years. In equitable distribution states, a court will consider numerous factors when deciding on an award of the house.

So, then, to whom does the house belong? Title on the deed is certainly a useful starting point, but it also depends on whether you live in a community property state or an equitable distribution state. It further depends on whether you owned the house prior to marriage, whether you received the house as a gift or inheritance, and whether both spouses lived in the house during marriage. It's important, therefore, to review the domestic relations law of your own state to answer this question satisfactorily. Nevertheless, in general, it's safe to say that both spouses probably have a claim on the house and should prepare to divide this asset along with other marital assets.

## **What can be done with the house when a divorce arises?**

When considering the issue of who gets the house, there are four options that are most frequently used: sell the house, have one spouse buy out the other's half, have both spouses continue to own the property jointly, or simply agree that the homemaker spouse (if any) should get the house along with other assets.

### **Sell the house**

Selling the house and dividing the profits that remain after the mortgage is paid off and the selling costs have been paid is certainly one of the easiest ways to deal with the marital residence, particularly when there are no children involved. Profits can be divided equally or otherwise, based on the parties' wishes. Most people will want to have an independent appraiser value the property, hire a real estate agent to sell it, consult with a real estate attorney, and obtain a mortgage payoff figure. These selling costs can sometimes be significant. For information about deducting settlement costs and other costs involved in the sale of a house, see [Selling a Home](#) .

Of course, the divorcing spouses will both need to find new residences and weigh the costs and benefits of purchasing a new home versus renting an apartment. If there are no children, selling the marital residence is probably a much simpler solution for a younger couple than for an older one. An older spouse, particularly a homemaker, may have stronger emotional ties to the home and may fear the loss of security associated with a sale of the home and a new life in an apartment.

### **Buy out the other spouse**

If one party wants to keep the family home, buying out the other spouse might be an attractive solution. You can buy out your spouse by trading another asset (like a pension) or foregoing alimony, by paying in cash, or by granting a mortgage (or second mortgage) to your spouse.

If you want to buy out your spouse, the first thing you'll need to do is to value the property. An independent appraiser should be hired to fix the value. Next, obtain a mortgage payoff figure (if any). The value minus the mortgage shall be viewed as your equity in the property and, once divided in half, can serve as the buyout figure. Alternatively, of course, the couple can decide on a buyout figure of their own choosing; it doesn't necessarily have to be one-half of the equity.



The method of payment is the next question to be considered. Certainly, trading assets is one option. For example, if one half of the net equity in the house amounts to \$25,000, and one spouse has a pension worth approximately \$15,000, the other spouse might want to relinquish his or her rights in the pension in return for keeping the house. Of course, the other spouse needs to carefully weigh such a decision, in light of the fact that the pension will probably increase dramatically over the years and he or she may be left with no retirement income.

A cash exchange is another method of payment, if one party has an inheritance or trust fund. Refinancings and mortgages should also be considered. The house could be refinanced to provide enough cash to pay the other spouse. Alternatively, a note payable (with reasonable interest) or private mortgage can be drawn up between the spouses. However, this approach could present some problems.

**Example(s):** *Mary and John are seeking a divorce and own a home with \$20,000 worth of equity. Mary wants to keep the house, but has just started a new job, and doesn't have sufficient cash on hand to buy out John. Mary promises to make a balloon payment of \$10,000 to John seven years after their divorce date, securing this promise with a \$10,000 private mortgage to John. When Mary tries to refinance the house some years later in order to pay off John, she finds that conventional mortgage lenders will not grant her a mortgage unless John subordinates his mortgage claim to theirs. If John refuses to subordinate, Mary will have difficulty finding the cash to pay off John.*

**Tip:** *If private notes and mortgages are to be used, the divorce agreement should stipulate that subordinations and other accommodations will be freely given by the creditor-spouse. Also, if one spouse merely deeds his or her interest in the house to the other spouse while a mortgage is outstanding, both spouses shall remain liable for the mortgage (if both signed the mortgage initially). If the spouse who lives in the house stops making mortgage payments, the other spouse may be liable and may suffer severe credit consequences.*

## **Joint ownership**

This option is often used when the parties envision selling the house at some point in the future (e.g., when the minor children reach age 18 or when the resident spouse remarries). The parties might agree that the spouse who lives in the house shall be responsible for making the mortgage payments or that both parties will pay the mortgage, insurance, and taxes until the children graduate from school.

Property values should be a concern, however, if you promise to pay a certain dollar amount in the future. Rather than promising to pay \$20,000 when the property is sold 15 years from now, you might wish to promise one-half or one-third of the net sale proceeds. This would protect the resident spouse if the property value declines. If you're the creditor-spouse, a dollar amount might be better.

## **Agree to give to homemaker**

There are cases when assets won't be traded in any significant sense; rather, the parties will simply agree to give the greater portion of assets to one spouse. This can be particularly true when a homemaker of many years is involved. For older women who sacrificed a career for the care of children and the upkeep of a house, it may be impossible for them to jump into the working world at age 58 and earn a sufficient living. In such cases, judges may decide simply to award the house to the homemaker. Additionally, the judge may order alimony payments for life and a portion of the pension set aside. Such measures may be deemed equitable under the circumstances.

Be aware, however, that the upkeep of a house and its grounds might be too burdensome and expensive for certain individuals.

## **What are the tax ramifications when a house is sold pursuant to a divorce?**

Generally speaking, property transfers between spouses during marriage or incident to divorce aren't taxable. However, the tax effects on the sale or transfer of your home incident to divorce can vary substantially, depending on whether you (as a couple) decide to keep the house, sell it to a third-party, or transfer it to one spouse with a view toward a future sale.

### **Transfer to one spouse incident to divorce**

Neither spouse recognizes gain or loss if you transfer the title of the home to your spouse incident to a divorce. A transfer of property is viewed as incident to a divorce if the transfer occurs within one year after the date on which the marriage ends or if the transfer is related to the ending of the marriage. Any transfer of property between spouses that is made pursuant to a divorce or



separation instrument and occurs within six years after the date the marriage ceases is presumed to be related to the cessation of the marriage.

## **Basis**

The spouse receiving the property takes the basis of the transferring spouse and ends up with the combined basis. This result occurs even if the spouse who retains the residence pays cash or other assets in return for the house and the transaction is basically a sale.

**Example(s):** Assume Mary and John own a home that is presently worth \$170,000. Mary sells her half-ownership of their home to her spouse, John, for \$85,000 as part of their divorce settlement. Because the property had initially been purchased for \$80,000, Mary's basis was \$40,000, and John's was \$40,000. Mary does not recognize any gain on the sale to John because the sale was incident to their divorce. John's basis in the property will be \$80,000.

## **Delayed sale of house**

The parties might decide (in their divorce agreement) that the house shall be sold at some point in the future. Typically, only one spouse remains in the house, but the other spouse continues to be listed on the deed as a joint owner. This raises a question concerning exclusion of the capital gain when the house is later sold.

In general, the law states that if all requirements are met, a taxpayer of any age can exclude from federal income tax up to \$250,000 of gain (up to \$500,000 for joint filers meeting certain conditions) from the sale of a home owned and used by the taxpayer as a principal residence for at least two of the five years before the sale. Generally, an individual (or either spouse in a married couple) can use this exemption only once every two years.

At first glance, this law would seem to preclude the spouse who moved away (and has lived elsewhere for several years) from claiming the exclusion. However, under the following circumstances, a separated or divorced taxpayer can "tack on" someone else's ownership and/or use period to his or her own ownership and/or use period:

- An individual is treated as using a home as his or her principal residence during any period of ownership that the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument
- An individual who receives a home in a tax-free transfer from one spouse to another may tack on the transferor's ownership period to his or her own ownership period

**Example(s):** Assume John and Mary are divorcing. They agree that Mary can continue living in the house until their daughter, Jane, turns 18 in eight years. At that time, the house will be sold and the proceeds split between John and Mary. In such a case, John will be eligible for the \$250,000 capital gains exclusion--even though he didn't reside in the family home for two of the past five years--since he met one of the exceptions.

In addition, even if you don't meet the two-out-of-five-years test or the one-exemption-every-two-years test, you may qualify for a partial exemption. You may claim a partial homesale exemption if the primary reason for selling your principal residence is a change in place of employment, for health reasons, or for certain other unforeseen circumstances. Regulations issued by the IRS specifically list divorce or legal separation as an unforeseen circumstance.

## **Sale of house to third party immediately**

Often, a house will be sold to a third party as part of a divorce settlement and the proceeds split between the spouses. In such a case, if the capital gain exclusion did not apply, the husband and wife would each recognize his or her proportionate share of the gain on the sale (based on the division of the sales proceeds). But this will not be the case if the husband and wife qualify for the capital gain exclusion mentioned above.

**Example(s):** Assume Mary and John are seeking a divorce. During the course of their marriage, they purchased a house for \$100,000 and there have been no adjustments to Mary and John's basis in their home. The house is now worth \$200,000, and the couple decides to sell it through a real estate broker and split the proceeds evenly. If their net proceeds from the sale amount to \$186,000, John and Mary will each experience a \$43,000 gain. Assuming they qualify for the capital gains exclusion, however, Mary and John can each exclude up to \$250,000 of gain from the sale of the home.

**Tip:** When structuring divorce settlements, the timing of property sales and the tax ramifications should always be considered, along with the domestic relations law (i.e., community property states versus equitable distribution states). It is wise, therefore, to consult with a divorce and/or tax attorney even if the property settlement appears to be a simple and amicable one.



# Qualified Domestic Relations Order (QDRO)

## What is a qualified domestic relations order (QDRO)?

A qualified domestic relations order (QDRO) is a court judgment, decree, or order establishing the marital property rights of a spouse, former spouse, child, or dependent of a pension plan participant with respect to certain qualified retirement plans. Several requirements and restrictions apply.

## To what extent are retirement assets subject to divorce court jurisdiction?

A retirement plan is a form of property. Like houses, cars, and bank accounts, a retirement plan can be divided between spouses at the time of a divorce. For example, if one spouse participates in a pension plan at work while the other spouse remains at home to care for the children, a judge has numerous options with respect to the retirement plan. Among other choices, he or she can award all of the pension to the working spouse, award all of it to the nonworking spouse, or split it equally (50/50). Judges often use QDROs to effect these pension assignments. In a marriage of long duration, a pension plan may be one of the most valuable marital assets.

## How are retirement plans classified?

Many different kinds of retirement plans exist, with individual retirement accounts ( IRAs ) being one of the more common forms. In terms of employer-sponsored retirement plans, plans are classified as either qualified or nonqualified. Basically, qualified plans are those that satisfy federal requirements and are afforded special tax treatment. Most qualified plans can be further categorized as either defined contribution plans or defined benefit plans.

- Defined contribution plans--Each participant in a defined contribution plan has an individual account. When you retire, you're entitled to receive your entire account balance. Funding depends on the type of plan. With some plans, the employees are the only ones who contribute, and with others, the employers do all the contributing or may match employee contributions dollar for dollar (or according to a certain percentage). Typical examples of defined contribution plans include 401(k) plans and profit-sharing plans.
- Defined benefit plans--A defined benefit plan does not use individual accounts. Instead, benefits for the participants in the plan are fixed under a particular formula. Specified benefits are paid to participants based on such factors as age, length of service, and amount of compensation. Generally, the plan promises to pay the employee a certain amount per month at retirement time based on enumerated factors.

Before you think about dividing pension plans, it's important to understand the difference between defined contribution plans and defined benefit plans.

## What requirements and restrictions apply to QDROs?

A QDRO provides for child support, alimony payments, or marital property rights for a spouse, former spouse, child, or other dependent of a qualified plan participant and is made pursuant to a state domestic relations law. It creates or recognizes the existence of the right of the individual other than the plan participant (i.e., the alternate payee) to receive all or a portion of a participant's benefits under a qualified retirement plan.

A QDRO must satisfy certain requirements. It must clearly specify:

- The name and last known mailing address of the participant and each alternate payee covered by the order
- The amount or percentage of the participant's benefits the plan must pay to each alternative payee (or the manner in which such amount or percentage is to be determined)
- The number of payments or periods to which the order relates, and
- Each qualified retirement plan to which the order applies

However, a QDRO may not require the plan to do any of the following:





- Mandate increased benefits
- Pay benefits to an alternate payee that must already be paid to a different alternate payee under another QDRO, or
- Provide a type or form of benefit (or any option) not otherwise provided under the plan

For instance, the QDRO can't require the plan to provide cost-of-living increases if the plan doesn't already have cost-of-living provisions. Furthermore, a spouse's plan can't allocate 60 percent of the benefits to his or her former spouse if 50 percent of the benefits had previously been allocated to another prior spouse.

## In what ways may retirement plans be divided pursuant to a QDRO?

The QDRO specifies what the plan administrator is to do with the spouse's share of the plan. If under the plan a participant has no right to an immediate cash payment, a QDRO can't require the plan administrator to make an immediate cash payment to a spouse. Instead, a QDRO will probably be used to segregate plan assets into a subtrust for the benefit of the alternate payee-spouse, with cash distributions made at the earliest time they would be permitted under plan provisions.

Defined contribution plans are easy to value because the money is in an individual account and the plan administrator usually provides a quarterly report of the value. Defined benefit plans can pose a problem, however, and often require the services of an actuary to ascertain the present value of the fund. An actuary may be necessary, for example, if your eventual pension payout is tied to your compensation during your three highest paid years.

**Example(s):** *John is 50 years old and has a defined benefit plan that has no cash value right now. When John retires, he currently expects to receive \$1,200 per month. His ex-wife, Mary, will get a portion of the payout. If there is a 50 percent split of the present value according to a QDRO, John and Mary will each get \$600 per month at retirement time. However, if John actually receives \$1,800 per month when he retires, Mary will still only get \$600 per month.*

### Segregation of plan assets

One option is to segregate the alternate payee's portion of the plan until the employee reaches retirement age. At that time, the alternate payee can access the funds. With this approach, the alternate payee is treated as a participant in the plan. The employee's defined contribution plan balance (or defined benefit plan accrued benefit) is valued as of a certain date, and that benefit is divided between the participant and the alternate payee in accordance with the QDRO. Once divided, the alternate payee is treated similarly to a terminated participant with a vested deferred benefit.

There are certain advantages to this approach. For example, if you're the alternate payee, you're probably assured of receiving some retirement income in the future. Also, you won't have to deal with the problems of how to invest your money right now and how to value the plan today.

However, staying in the plan maintains your economic ties with your ex-spouse, so you might lose some money if your ex-spouse takes early retirement. Also, you will not be able to control the investment decisions for your share of the retirement assets. And finally, your share of the plan will generally not be accessible to you until your ex-spouse reaches retirement age.

### Current distribution of plan assets

If the plan allows, the plan administrator can distribute (to the alternate payee) the full amount of money due. The alternate payee can then either keep the money and pay tax on it now, or roll it into an IRA within 60 days, delaying taxation until later. There are also certain advantages to this approach. For example, if you need cash now for living expenses, you can keep all of the distribution. Also, you're able to control the investment decisions.

There are some drawbacks. For example, you may be subject to income tax (and perhaps the 10 percent penalty tax) if you don't roll the money into an IRA account within 60 days. Also, requesting a current distribution requires you to make your own investment decisions. And finally, you'll lose the long-term tax-sheltering advantage as well as the retirement savings if you spend the money now.

**Tip:** *The IRS has authority to waive the 60-day rule for rollovers under certain circumstances, such as proven hardship.*

## Aside from QDROs, what options may spouses consider with respect to retirement plan assets?



One option is to trade retirement assets for something else. For example, a divorcing couple can simply decide that one spouse gets the entire retirement plan and the other gets the house plus alimony. Or perhaps the other spouse gets a big cash buyout right now instead of a claim on the pension assets.

There are advantages to avoiding QDROs. You will save time and money by not having to draft a QDRO. QDROs can be very expensive, especially when actuaries must be hired. Trading assets can simplify the property settlement considerably, which saves attorney's fees. Also, you may be able to trade for an asset you really want, like the house.

However, you may jeopardize your future financial security if you relinquish pension rights today. Also, you and your spouse may not have enough other assets to make a fair division if one of you keeps the entire retirement plan. And if the retirement plan is a defined benefit plan, it will have to be valued in order to determine what amount of other assets would make an equitable offset.

**Tip:** Remember that QDROs don't apply to most nonqualified retirement plans, such as certain annuity plans and certain deferred compensation plans. So, if your spouse's plan is a nonqualified one, the specific QDRO rules may not have to be followed.

**Tip:** Also, the QDRO rules don't apply to IRAs. Nevertheless, it is possible for a QDRO to require a distribution of pension benefits to an employee and then a transfer of the distribution to an IRA for the benefit of the former spouse.

## When retirement plans are divided pursuant to a court order, what are the income-tax ramifications?

- Tax impact of QDRO on plan participant--If a QDRO orders a distribution of funds from a participant's plan to a spouse or former spouse, those funds will not represent taxable income to the plan participant. The 10 percent early withdrawal penalty will not apply. If the alternate payee is a child or dependent (rather than a spouse), then the distribution will be taxed to the plan participant. In such a case, the 10 percent early withdrawal penalty will still not apply.
- Tax impact on plan participant if there is no QDRO--If there is no QDRO and retirement plan assets are distributed to a spouse (or anyone else), then the distribution will be taxed to the plan participant. Furthermore, the 10 percent early withdrawal penalty may apply. Beware, also, of withholding requirements.
- Tax impact of QDRO on former spouse (or alternate payee)--A spouse or former spouse who receives a distribution under a QDRO steps into the shoes of the plan participant. As a result, such distributions become taxable to the spouse rather than to the plan participant. The money will be included in the alternate payee's gross income for the year of distribution. However, any cost basis that the participant had in the plan must be apportioned. It will be allocated on a pro rata basis between the present value of the alternate payee's interest and the total present value of all the benefits payable with respect to the plan participant.

**Example(s):** Assume John was married to Mary and had a vested balance in his 401(k) plan of \$300,000. John had made after-tax contributions to the plan in the amount of \$30,000. When John and Mary negotiated a divorce, it was decided that Mary would get 50 percent of the plan assets immediately (\$150,000). John's \$30,000 after-tax basis in the plan will be allocated to him and Mary based on the ratio of their respective interests in the plan. Thus, \$15,000 of the \$150,000 distribution to Mary will be nontaxable. The remaining \$135,000 will be taxable to Mary unless she rolls this money over into an IRA within 60 days of receipt. Since the distribution was made pursuant to a QDRO, there will not be a 10 percent early withdrawal penalty.

**Tip:** Distributions to children and other dependents will be taxable to the plan participant.

- If the alternate payee is the spouse or former spouse, the taxable part of any distribution received by such person will qualify as an eligible rollover distribution. Thus, it can be rolled over into an IRA within 60 days of receipt. If the alternate payee is a child or other dependent, the money may not be rolled over into an IRA.
- Tax impact on former spouse if there is no QDRO--If there is no QDRO, the former spouse doesn't include the distribution in gross income; the distribution is taxable to the plan participant. Also, the plan participant may be subject to the 10 percent early withdrawal penalty. Such a distribution doesn't qualify to be rolled over into an IRA.

**Tip:** Distributions from a Section 457 plan made pursuant to a QDRO are taxed under the same rules that apply to qualified plans.



# Filing Status Considerations: Divorce

## What are filing status considerations?

If you're separated, considering a divorce, or are already divorced, you should be aware of the income tax ramifications of your divorce-related financial decisions. An important consideration should be the filing status you select for your federal income tax return. Your filing status is important because it determines (in part) the deductions and credits available to you, the amount of standard deduction that you may be entitled to, and your correct amount of tax. Depending on your situation, you may or may not have a choice regarding your filing status. Generally speaking, there are four filing statuses available to individuals who are divorced or are considering a divorce: single (unmarried), married filing jointly, married filing separately, and head of household.

Thorough familiarity with the concept of filing status also involves some understanding of the innocent spouse rules, as well as divorce timing considerations.

## For filing status purposes, when are you considered married or unmarried?

Your selection of a filing status for a given year will depend on your marital status as of the last day of your tax year (usually December 31).

**Example(s):** Assume you marry on December 31, 2016. You'll be considered married for all of 2016. Assume, instead, that you married on December 31, 2015 and divorce on December 31, 2016. You'd be considered married for all of 2015 but unmarried for all of 2016.

### Divorce and separate maintenance decrees

You're considered unmarried for the entire year if, on the last day of your tax year (usually December 31), you're unmarried or legally separated from your spouse by a divorce or separate maintenance decree.

**Caution:** You're still considered married if you're separated under an interlocutory (not final) decree of divorce.

**Caution:** State law governs your legal status under a decree of separate maintenance. If the domestic relations laws of your state view you as married when a separate maintenance decree has been issued, you're considered married for purposes of filing federal income tax returns.

**Caution:** If you and your spouse obtain a divorce solely for the purpose of filing tax returns as unmarried individuals (with the intent to remarry) and you remarry the same individual the following tax year, you and your spouse will be treated as if you were never divorced.

### Legal annulments

If you obtain a court decree of annulment (which holds that no valid marriage ever existed), you are considered unmarried for the tax year, provided that you have not remarried.

**Tip:** You must also file amended federal income tax returns (IRS Form 1040X) for all tax years affected by the annulment (if not barred by the statute of limitations). These returns should amend previously filed tax returns to single (or head of household, if you qualify) filing status. The statute of limitations generally doesn't expire until three years after your original return was filed.

### Married persons living apart

Generally, if you live apart from your spouse but are not legally separated by a decree of divorce or separate maintenance, you're still considered married. However, if you meet all of the following requirements in addition to living apart from your spouse, you're considered unmarried for the entire year:

- You file a separate return (meaning that you don't file jointly),
- You paid more than half the cost of keeping up your home for the tax year,



- Your spouse did not live in your home during the last six months of the tax year, and
- Your home was, for more than half the year, the main home of your child, stepchild, or adopted child, whom you can claim as a dependent. This qualification is also met if your home was the main home of a foster child (whom you can claim as a dependent) for the entire year.

If you're considered unmarried under the above requirements, you probably will qualify for head of household status.

## **Common law marriage**

You're considered married if you live in a common law marriage that is recognized in the state where you now live or in the state where the common law marriage began. This is true even if you later moved to a state that does not recognize common law marriage.

## **Same-sex marriage**

Same-sex marriages are now recognized by every state and the federal government. However, for federal tax purposes, marriage does not include registered domestic partnerships, civil unions, or similar formal relationships recognized under state law.

## **What filing status should you select?**

Taking into consideration that marital status is determined on the last day of the year (December 31), the following rules will apply:

### **Single**

You must select single as your filing status if you were unmarried as of the last day of the tax year and were not eligible to claim head of household, or qualifying widow(er) status.

### **Head of household**

The head of household rules vary, depending on whether you're unmarried (including divorced) or married.

If you're unmarried:

- You must provide more than one-half of the costs of maintaining your household, and
- Your household must be the principal home of at least one dependent.

If you're married:

- You must file a separate return,
- You must maintain your home and have your child or stepchild living there for more than one-half of the tax year,
- You must claim the child as a dependent or waive that claim,
- You must furnish more than one-half of the cost of maintaining the household during the tax year, and
- Your spouse must not have lived in your household at any time during the last six months of the year.

**Example(s):** Assume John and Mary have an eight-year-old son, Jimmy. John and Mary obtain a divorce on January 1, 2016, whereby Mary is awarded custody of Jimmy. Jimmy lives with Mary throughout the year. When Mary files her 2016 tax return, she can file using head of household status.

### **Married filing jointly**

You and your spouse (or former spouse) can choose to file a joint return if you were married to each other through the last day of the tax year, even if you were living apart. If living apart, you can't file as married if you are legally separated under a final decree of divorce or separate maintenance. You can, however, file as married if you are separated under an interlocutory (not final) decree of divorce.

**Example(s):** Assume John and Mary unofficially separate on February 1, 2015. Mary continues to reside in the family house, while John rents an apartment. On September 8, 2016, they divorce. When considering their 2015 tax situation, John and Mary can choose to file a married filing jointly return, since they remained married through December 31, 2015.

### **Married filing separately**





You can select married filing separately as your filing status if you're married or if you're no longer married but had remained married to your former spouse up to and including the last day of the tax year (December 31).

**Tip:** *If you and your spouse are unable to agree on which filing status to select, you should file separately. This is because your two separate returns can be amended later (if necessary) into a married filing jointly return. The opposite is not true, however; you can't subsequently amend a joint return into two separate returns.*

## What other filing status considerations should you keep in mind?

You should know how the timing of your divorce can impact your tax liability. Also, joint filers should be aware of the rules for innocent spouse relief.

### Timing of divorce

If filing as married individuals (either jointly or separately) would be more beneficial than each of you filing as single, consider delaying a divorce until after the end of the tax year. Conversely, finalizing a divorce before the end of the tax year will allow both of you to file as unmarried individuals; that is, as single or, if one of you qualifies, as head of household.

**Tip:** *If you desire to file as a single individual, also, consider obtaining a decree of separate maintenance before the end of the tax year. This will also allow you to file your tax return for the year as an unmarried individual.*

### Innocent spouse relief

If you file a joint return, each spouse is generally jointly and severally liable for 100 percent of the taxes due on the return (as well as for any penalties and interest assessed). Even after your divorce is finalized, you will be liable for any unpaid taxes attributable to prior years unless you qualify for relief as an innocent spouse.

**Tip:** *If you're going to file a joint return while in the process of a divorce or separation, consider utilizing an indemnification clause or an escrow arrangement as a way of protecting yourself from future liability. An indemnification clause is a clause within a divorce decree that states that one spouse agrees to reimburse the other for future tax liabilities. An escrow arrangement can be used to set aside funds for estimated future taxes that will be due as the result of a joint return.*

**Caution:** *The IRS doesn't care whether you have an indemnification clause or an escrow arrangement. The IRS can still collect any tax deficiency from either you or your former spouse.*



# Am I liable for my spouse's debts?

## Answer:

The general rule is that spouses are not responsible for each other's debts, but there are exceptions. Many states will hold both spouses responsible for a debt incurred by one spouse if the debt constituted a family expense (e.g., child care or groceries). In addition, community property states will hold one spouse responsible for the other's debts because both spouses have equal rights to each other's income. Also, you are both responsible for any debt that you have in both names (e.g., mortgage, home equity loan, credit card).



# My husband and I are divorcing. Will I continue to receive Social Security based on his record?

## Answer:

Yes. If you already receive Social Security based on his earnings record, you'll continue to receive it as long as you live (or in some cases, until you remarry). If you don't receive Social Security yet, you can apply for a reduced benefit when you turn 62 or wait until your full retirement age if you want to receive an unreduced spousal retirement benefit. If you've been divorced for more than two years, you can apply as soon as your ex-husband becomes eligible for benefits, even if he hasn't started receiving them (assuming you're at least 62). However, if you've been divorced for less than two years, you must wait to apply for benefits based on your ex-husband's earnings record until he starts receiving his own benefits.

You don't have to worry about losing your benefit even if your ex-husband remarries. Benefits for a divorced spouse are calculated separately from those of a current spouse.



# My husband and I are divorcing. Whose health insurance policy will cover the children?

## Answer:

As parents, both of you will want to keep the best interests of your children in mind. That means you should compare your health plan with your spouse's health plan and determine which one offers the most comprehensive health coverage and flexibility in choosing health-care providers.

Your ultimate decision will also involve other considerations, such as job security. If you and your spouse are eligible to participate in employer-sponsored group health insurance plans, which of you is more likely to remain employed? Expense is probably another issue you'll face. If your employer pays a larger portion of the premiums than your spouse's employer pays, your spouse may argue that you should cover the children under your health plan. If you have custody of the children, though, you may find the extra expense too burdensome.

The issues of child support and child custody are quite relevant when you discuss health insurance coverage of the children. For example, if you have custody of the children, receive child support, and need your spouse to provide health insurance coverage for the children, you may be able to obtain a court order (if necessary) to ensure his or her compliance. This is known as a qualified medical child support order.

You'll resolve the issue of health coverage--and many other issues--during your divorce settlement negotiations. Because state divorce laws may vary, you should seek advice from a divorce attorney before making any decisions.





# How do I protect my assets in the event of a divorce?

## Question:

How do I protect my assets in the event of a divorce?

## Answer:

If protecting your assets means that you want to keep all of your money, property, and possessions out of your soon-to-be ex-spouse's hands, you're probably out of luck. Any assets acquired during marriage are considered marital property and must be divided according to state law.

If you live in a community property state (i.e., California, Texas, or one of eight other states), you and your spouse must split any marital assets equally. However, in all other states, assets must be divided equitably (fairly) rather than equally. Your best protection is to make sure that your interests are represented. Hire an experienced attorney who will help you negotiate a fair settlement.

Don't shortchange yourself by overlooking hidden assets. For instance, you may know your joint savings account balance and what possessions you must divide, but do you know the balance of your spouse's pension plan? Does your spouse own a prepaid life insurance plan? Does your spouse have retirement funds (e.g., 401(k), IRAs) in his or her own name? These things will be considered marital assets as well.

Finally, don't forget about debt. In general, you'll be responsible for any debt acquired during the marriage, even if you didn't run up the debt yourself. Make sure that the divorce settlement states who will be responsible for paying off all debts, and close all joint accounts.



# Are alimony payments considered taxable income?

## Question:

Are alimony payments considered taxable income?

## Answer:

Alimony is a support payment made to a former (or separated) spouse under a divorce decree or separation instrument in an attempt to maintain the predivorce lifestyle. Alimony is sometimes called maintenance. Simply stated, alimony is taxable income to the one who receives it and tax deductible to the one who pays it. To be considered alimony under present tax rules, however, the payments must meet several requirements.

These requirements include (but are not limited to) the following:

- All payments must be made in cash, check, or money order
- A written court order or separation agreement must exist regarding the alimony
- The order or agreement must not designate the payment as not being alimony (i.e., it cannot be designated as child support)
- The couple generally cannot live in the same household while alimony is being paid (although an exception applies in the case of payments to a separated spouse living in the same household if the payments are made under a written separation agreement, support decree, or other court order)
- The obligation to pay alimony cannot continue past the death of the payor-spouse
- The former spouses cannot file a joint tax return

You should also be aware of the alimony recapture rules. Because alimony is tax deductible, some spouses are tempted to disguise property settlement payments as alimony. They might accomplish this by front-loading alimony during the first couple of years. That is, one spouse might agree to pay high sums of alimony during the first two years after the divorce, and to continue with normal payments thereafter. According to the alimony recapture rules (which are fairly complex), deductible alimony payments will be recharacterized as nondeductible property settlement payments to the extent that payments made during the first two years are excessively front-loaded.

For more information, consult a tax professional.



# What are the tax implications of child support payments?

## Question:

What are the tax implications of child support payments?

## Answer:

When a separation or divorce occurs and the couple involved has one or more children, the noncustodial parent is usually ordered to pay some child support to the custodial parent. The child's expenses over and above this sum are generally borne by the custodial parent. Whether you are paying or receiving child support, you should be aware of the federal income tax consequences. You are not taxed on child support that you receive, and you cannot deduct child support that you pay.

Payments will be classified as child support for federal income tax purposes if the divorce decree or separation agreement:

- Fixes a sum that is payable for the support of a child (this can be either a dollar amount or a specific fraction of a payment), or
- Provides that the amount payable by the payor-spouse to the receiving spouse will be reduced when a contingency relating to a child actually happens, or at a time that can clearly be associated with a contingency relating to a child

For example, John agrees to pay his ex-wife, Carol, \$2,500 per month until she dies. (Note that the words child support are not specifically mentioned.) Carol has custody of their child, Justin. The divorce agreement states that upon a certain date, John's required payment to Carol will decrease by \$800. Because Justin will turn 18 within six months of the date on which the payment is scheduled to decrease, the payment reduction is assumed to be related to Justin's reaching 18 years old. Therefore, the \$800 per month reduction is treated as child support, regardless of the parties' intent.

From a tax perspective, being a custodial parent can be advantageous in terms of claiming the child dependency exemption and the child-care credit. In addition, the custodial parent can potentially qualify for head of household filing status.

## IMPORTANT DISCLOSURES

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